

### III. SUMMARY OF FACTS

#### A. San Diego's City Government

##### 1. Charter City

The City of San Diego is a Charter City, which means it is governed by a City Charter (the "Charter") that functions as the Constitution for the City. The Charter sets forth the roles and responsibilities of the elected officials of the City, including the Mayor, City Council, and City Attorney, as well as those of the primary appointed officials of the City, including the City Manager and the City Auditor and Comptroller. As of January 1, 2006, the City of San Diego adopted a "Strong Mayor" form of government;<sup>81</sup> therefore, the following discussion pertains to the structure of the City government as it existed prior to January 1, 2006.

##### 2. City Manager's Authority

During the period covered by this report, the position of City Manager was elected by the City Council to an indefinite term.<sup>82</sup> He could be removed by the Council with a simple majority vote.<sup>83</sup> The City Manager could attend Council meetings and participate in discussions but could not vote.<sup>84</sup> He was expected to inform the Council of all "significant developments" or "material facts" relating to matters under the Council's jurisdiction.<sup>85</sup>

The City Manager was entrusted with significant powers that made him critical to the proper functioning of the City. The City Manager was responsible for supervising the administration of the City, making recommendations to the Council about the City's administration, advising the Council of the City's fiscal health, preparing and submitting an annual budget to the Council, and enforcing the ordinances of the City and the laws of the State.<sup>86</sup> As the City's chief budget officer, the City Manager was required to prepare annually a financial plan for the following year and administer that plan.<sup>87</sup> The City Manager could set aside or supersede any action taken by any department director.<sup>88</sup> Furthermore, the City Manager had the power to

---

<sup>81</sup> See generally San Diego City Charter art. XV.

<sup>82</sup> San Diego City Charter art. V, § 27.

<sup>83</sup> San Diego City Charter art. V, § 27.

<sup>84</sup> San Diego City Charter art. V, § 32.

<sup>85</sup> San Diego City Charter art. V, § 32.1.

<sup>86</sup> San Diego City Charter art. V, § 28.

<sup>87</sup> San Diego City Charter art. V, § 28.

<sup>88</sup> San Diego City Charter art. V, § 28.

“appoint and remove all officers and employees in the administrative service of the City under his control.”<sup>89</sup> As a practical matter, the City Manger ran the City on a day-to-day basis.

### **3. The City Council**

The City Council was composed of nine individuals: eight elected Council members, representing each of the eight City districts, and the Mayor, who was elected by a City-wide vote.<sup>90</sup> All members of the Council were elected to serve four-year terms and could not serve more than two consecutive four-year terms.<sup>91</sup> Council members were expected to serve full-time in their elected positions and have no outside employment or business interests which interfered with their duties.<sup>92</sup>

The Council chose – and could remove – the City Manager.<sup>93</sup> A vote to remove the City Manager required a vote by the majority of members of the Council.<sup>94</sup> The Council also had the power to set the salaries of all City employees, including the City Manager, City Clerk, City Treasurer, City Auditor and Comptroller, and all other officers under its jurisdiction.<sup>95</sup> The Council had the power to contract for bond indebtedness.<sup>96</sup>

### **4. The Mayor**

The Mayor of the City of San Diego was elected by a City-wide vote in an election that was held once every four years.<sup>97</sup> The Mayor was limited to serving two consecutive four-year terms.<sup>98</sup> The Mayor was the official head of the City for all ceremonial purposes.<sup>99</sup> The Mayor presided over Council meetings and had a vote as a member of the Council, but had no veto power and in most respects was simply another

---

<sup>89</sup> San Diego City Charter art. V, § 29.

<sup>90</sup> Prior to 1998, the members of the City Council were nominated within their districts but elected by a City-wide vote. In 1998, San Diego voters approved a referendum changing the election system so that both nominations and elections for Council were by district. A History of San Diego Government, *available at* [www.sandiego.gov/city-clerk/history.shtml](http://www.sandiego.gov/city-clerk/history.shtml).

<sup>91</sup> San Diego City Charter art. III, § 12.

<sup>92</sup> San Diego City Charter art. III, § 12.

<sup>93</sup> San Diego City Charter art. V, § 27.

<sup>94</sup> San Diego City Charter art. V, § 27.

<sup>95</sup> San Diego City Charter art. VII, § 70.

<sup>96</sup> San Diego City Charter art. VII, § 90.

<sup>97</sup> San Diego City Charter art. II, § 10.

<sup>98</sup> San Diego City Charter art. IV, § 24.

<sup>99</sup> San Diego City Charter art. IV, § 24.

member of the Council.<sup>100</sup> The Mayor had the responsibility for appointing members of all Commissions.<sup>101</sup> Since January 1, 2006, the City of San Diego has had a “Strong Mayor” form of government, which has enhanced the powers of the Mayor and subordinated the roles of other City officials.<sup>102</sup>

## **5. The City Auditor and Comptroller**

Like the City Manager, the City Auditor and Comptroller was selected by the Council for an indefinite term.<sup>103</sup> As the chief fiscal officer of the City, the City Auditor and Comptroller supervised all accounts and submitted to the City Manager and the Council a summary of revenues and expenses on at least a monthly basis, for the preceding accounting period.<sup>104</sup> He provided the City Manager with information required for the preparation of the annual budget.<sup>105</sup> Unless the Auditor and Comptroller certified in writing that an appropriation had been made to cover the expenditure requested and sufficient funds existed to pay the expenditure, no contract for the expenditure was valid.<sup>106</sup> Additionally, he was principally responsible for compiling and updating the information in the City’s comprehensive annual financial reports (“CAFRs”).<sup>107</sup>

## **6. The City Attorney**

The City Attorney was elected in a City-wide vote held once every four years.<sup>108</sup> No City Attorney could serve more than two consecutive four-year terms.<sup>109</sup> As the chief legal adviser and attorney for

---

<sup>100</sup> San Diego City Charter art. IV, § 24.

<sup>101</sup> San Diego City Charter art. V, § 41.

<sup>102</sup> *See generally* San Diego City Charter art. XV. As of January 1, 2006, the Mayor of the City of San Diego is now the Chief Executive Officer of the City; appoints, directs, controls and has the sole power to dismiss the City Manager; has the authority to dismiss the City Auditor and Comptroller; and proposes a budget to the Council. The Mayor, with limited exceptions, can veto any ordinance or resolution passed by the Council. However, the Council can reconsider any Mayoral veto and if at least five members of the Council vote in favor of the legislation’s passage, it becomes effective notwithstanding the Mayor’s veto. San Diego City Charter art. XV, § 285. The provisions of Article XV of the San Diego City Charter are in effect for five years, from January 1, 2006, until being automatically repealed on December 31, 2010. The Council and the residents of San Diego have the ability from now until the election of November 2010 to make permanent, extend, shorten or repeal the effective period of Article XV. San Diego City Charter art. XV, § 255.

<sup>103</sup> San Diego City Charter art. V, § 39.

<sup>104</sup> San Diego City Charter art. V, § 39.

<sup>105</sup> San Diego City Charter art. V, § 39.

<sup>106</sup> San Diego City Charter art. V, § 39.

<sup>107</sup> *See, e.g.,* City of San Diego, California, Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002 (Nov. 27, 2002).

<sup>108</sup> San Diego City Charter art. II, § 10.

<sup>109</sup> San Diego City Charter art. V, § 40.

the City and all departments and offices of the City, the City Attorney had many responsibilities, including providing advice in writing when so requested to the Council, its committees, the City Manager, the commissions, or the directors of any department.<sup>110</sup> He was also responsible for “prepar[ing] in writing all ordinances, resolutions, contracts, bonds or other instruments in which the City is concerned, and . . . endors[ing] on each approval of the form or correctness thereof,” and performing “all services incident to the legal department.”<sup>111</sup>

The City Attorney was the sole legal advisor for the City but, according to the Charter, the Council had the ability to hire outside counsel under limited circumstances.<sup>112</sup> The City Council provided funding to the City Attorney’s Office in the annual appropriation ordinance, including money for the Office to hire outside counsel.<sup>113</sup> The Charter did not explicitly empower the Mayor to hire outside counsel. It is unclear from the City Charter whether the Council had the ability to direct the actions of the City Attorney, who was an independent elected official and not appointed by the Council.

## **B. How SDCERS Operates**

The City of San Diego, as an employer, provides its employees with various retirement benefits. The amount, timing, and conditions of these benefits are all matters of negotiation between the City and its employees, most of whom are unionized, and change over time. The City funds the retirement benefits it has agreed to provide by requiring employees to make annual contributions to SDCERS and by making its own contributions.<sup>114</sup> The function of SDCERS is to administer the funds contributed by City employees and the City in such a way as to be able to pay the current and anticipated future benefits that the City has agreed to pay to current and retired employees.<sup>115</sup> In other words, the City is responsible for funding the benefits and SDCERS is responsible for administering the benefits and the plan assets.

---

<sup>110</sup> San Diego City Charter art. V, § 40.

<sup>111</sup> San Diego City Charter art. V, § 40. The final phrase, which is extremely vague, appears to be undefined both in the Charter and all relevant City authorities.

<sup>112</sup> “The Council shall have authority to employ additional competent technical legal attorneys to investigate or prosecute matters connected with the departments of the City when such assistance or advice is necessary in connection therewith. The Council shall provide sufficient funds in the annual appropriation ordinance for such purposes.” San Diego City Charter art. V, § 40.

<sup>113</sup> San Diego City Charter art. III, §§ 11.1 and 16; San Diego City Charter art. IV, § 40. “The salary of the City Attorney shall be fixed by the Council and set forth in the annual appropriation ordinance.” San Diego City Charter art. V, § 40; “The Council may reduce or eliminate any new item, may increase any amount or add any item for personal services, contractual services, materials, supplies, and equipment for any Department.” San Diego City Charter art. VII, § 71.

<sup>114</sup> San Diego City Charter art. IX, § 143.

<sup>115</sup> Cal. Const. art. XVI, § 17.

The SDCERS pension is a defined benefit plan in which vested members receive a specified portion of their annual salaries when they retire.<sup>116</sup> For an employee to vest, he or she must serve a specified period of time as a member of SDCERS.<sup>117</sup> SDCERS invests the contributions it receives from employees and the City in stocks, bonds and real estate, and reinvests dividends, interest earnings and capital gains from the sale of securities.<sup>118</sup>

At any given point in time, it is possible to estimate the sum total of the City's retirement obligations, or its Actuarial Accrued Liability ("AAL"). The City's AAL is the total amount (reduced to present value using an assumed rate of return) that it owes under its existing agreements to employees who have already retired and to current employees (based on service rendered to date) who can be expected to retire with a vested pension.<sup>119</sup> The AAL is the amount of money the City would need to have invested today so that the principal together with the income it is expected to earn is sufficient to pay these obligations as they come due.<sup>120</sup> The AAL is not reported as a liability in the City's financial statements.

Calculating the City's AAL requires numerous judgments, none of which can be made with scientific certainty: How long are retirees likely to live? What is their expected compensation over the course of their career? How long are current employees likely to continue working before retirement? How many current employees are likely to leave the City's employ before their benefits vest? What is a reasonable rate of return to expect on the retirement assets that SDCERS has invested to pay future benefits? Using the best available information as of a given date, a reasonable estimate can be made.

Just as it is possible to estimate the SDCERS AAL at any given point in time, it is also possible to calculate the SDCERS actuarial value of assets ("AVA"), the cash and investments that it has on hand to meet the City's pension obligations. Because the AAL has already been reduced to present value, that is, expressed as a dollar amount needed today in order to meet all future obligations, the AAL and AVA

---

<sup>116</sup> About SDCERS, SDCERS History and Purpose, *available at* [www.sdcers.org/about\\_history.jsp](http://www.sdcers.org/about_history.jsp).

<sup>117</sup> [www.sdcers.org/about\\_history.jsp](http://www.sdcers.org/about_history.jsp). Under the San Diego Charter, most City employees vest after ten years of service. San Diego City Charter art. IX, § 141.

<sup>118</sup> About SDCERS, SDCERS History and Purpose, *available at* [www.sdcers.org/about\\_history.jsp](http://www.sdcers.org/about_history.jsp).

<sup>119</sup> STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING: USING THE GASB 34 MODEL 676 (Government Finance Officers Association 2005); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1996, at 53 (Jan. 9, 1997).

<sup>120</sup> STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING: USING THE GASB 34 MODEL 676 (Government Finance Officers Association 2005); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1996, at 53 (Jan. 9, 1997).

should be directly comparable.<sup>121</sup> If the AVA is less than the AAL, then the pension plan is underfunded and SDCERS has an Unfunded Actuarial Accrued Liability (“UAAL”).<sup>122</sup> Since 1995, SDCERS has almost never been fully funded, although the amounts of its UAAL have varied widely.<sup>123</sup>

To fund current payments to retired City employees who are receiving retirement benefits, SDCERS uses the cash it receives from payroll contributions by employees, contributions from the City, and cash from investment income from its investment assets.<sup>124</sup> SDCERS also accumulates funds to meet future retirement obligations to current employees through annual employee and City contributions.

Until the enactment of Manager’s Proposal 1 (“MP-1”) in 1996, the City contributed to the pension system an amount equal to its Annual Required Contribution (“ARC”). This amount was calculated each year by the SDCERS actuary and consisted of two components: (1) the City’s share of funds needed to meet the future benefits rights of current City employees arising from their continued employment that year, using an acceptable funding method; and (2) an amount sufficient to amortize any pre-existing UAAL over a specified period of time. If the City contributes less than its ARC in any given year, accounting rules require it to report in its financial statements a Net Pension Obligation (“NPO”) equal to the cumulative difference between its ARC and the amount of its actual contribution.<sup>125</sup>

SDCERS made use of two types of reserves as part of its funding approach. The first type of reserve account was contained within plan assets, and was used to track various expenditures but had no impact on the actuarial valuation or the plan’s funded status.<sup>126</sup> The second type of reserve was set outside of plan assets and was dedicated to cover specific benefits.<sup>127</sup> Because the funds contained in this type of reserve

---

<sup>121</sup> STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING: USING THE GASB 34 MODEL 676 (Government Finance Officers Association 2005); Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 1996, at 53 (Jan. 9, 1997).

<sup>122</sup> STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING: USING THE GASB 34 MODEL 715-16 (Government Finance Officers Association 2005); Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 1996, at 54 (Jan. 9, 1997).

<sup>123</sup> From fiscal year 1995 through fiscal year 2004, the SDCERS funded ratio was measured to exceed 100% only one time, during fiscal year ended June 30, 2000. San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 2004, at 13 (Jan. 14, 2005).

<sup>124</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 1996, at 4 (Jan. 9, 1997).

<sup>125</sup> Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶¶ 20 to 21 (June 30, 2005).

<sup>126</sup> As of June 30, 2003, the SDCERS reserve accounts contained within plan assets were the Member Deposit Reserve, the Employer Contribution Reserve, the Retired Members Reserve, the Undistributed Reserve, the Encumbrance Reserve, the Receivables Reserve, the Fixed Assets Reserve, Payables, and Unrealized Appreciation.

<sup>127</sup> As of June 30, 2003, the SDCERS reserve accounts held outside plan assets were the DROP Reserve, the Retiree Health 401(h) Reserve, the Supplemental COLA Reserve, and the Employee Contribution Rate Increase Reserve.

were not available to satisfy the general liabilities of the pension plan, their existence did affect the actuarial valuation and the plan's funded status. While SDCERS's extensive use of reserve accounts was unusual for retirement systems, it did not result in a significantly different financial picture than other, more typical methods.<sup>128</sup>

### C. The "Waterfall"

In 1980, the City wanted to increase benefits to retirees, whose pensions were deteriorating in value due to significant inflation.<sup>129</sup> At the same time, SDCERS investments had produced more income than the 8% of assets that it assumed to be its long-term average return on assets.<sup>130</sup> Rather than simply enacting an enhanced retirement benefit, the cost of which would be included in the SDCERS AAL and eventually paid through increased City contributions to SDCERS, the City Council passed a resolution defining all investment earnings in excess of 8% as "Surplus Earnings" and directing that 50% of Surplus Earnings be used to pay enhanced retiree benefits.<sup>131</sup>

The 1980 legislation, and the SDCERS compliance with it, involved a significant conceptual error. The SDCERS investment target of 8% is a prediction of how its investments are likely to perform over the long run.<sup>132</sup> Returns in excess of 8% in a single year are not truly "surplus;" they are needed to offset returns below 8% in future years.<sup>133</sup> Moreover, because returns above 8% are expected to remain within the system, they are included in the SDCERS annual calculation of its AVA.<sup>134</sup> Raiding these funds to pay current obligations reduces the SDCERS AVA and thereby increases its UAAL.<sup>135</sup> Designating earnings in excess of 8% as "surplus" made it look as if the City could grant additional retirement benefits without providing a funding source for them. This impression was (and is) misleading and dangerous.

---

<sup>128</sup> Telephone conversation between Steve Metz, Pricewaterhouse Coopers LLP, and the Audit Committee (July 21, 2006).

<sup>129</sup> San Diego, Cal., Ordinance O-15353 (Oct. 6, 1980).

<sup>130</sup> Minutes, SDCERS Board Meeting at 8 (July 11, 2002).

<sup>131</sup> San Diego, Cal., Ordinance O-15353 (Oct. 6, 1980).

<sup>132</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1996, at 45 (Jan. 9, 1997).

<sup>133</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 15 (Feb. 12, 2002).

<sup>134</sup> STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING: USING THE GASB 34 MODEL 676 (Government Finance Officers Association 2005).

<sup>135</sup> STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING: USING THE GASB 34 MODEL 715-16 (Government Finance Officers Association 2005); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1996, at 54 (Jan. 9, 1997).

The 1980 Council action was not necessarily either wrong or imprudent. There is nothing sacred about the SDCERS assumption that its investments would earn 8% over the long run, and SDCERS could properly have concluded that this assumption was too conservative. In fact, for most of the 1980s and 1990s it was. If SDCERS had used a higher (and supportable) assumed rate of return, say 10%, this changed assumption would have reduced its estimated AAL, because at any given point in time the present value of future obligations is lower if one assumes a higher rate of return on current assets. Lowering the City's estimated AAL would, in turn, lower the City's UAAL, which is simply the difference between its estimated future obligations reduced to present value, and the value of assets on hand to pay these future obligations.<sup>136</sup> Because part of the City's ARC goes to pay down the UAAL over time, a lower UAAL means a lower annual ARC for the City.<sup>137</sup>

Thus, if the SDCERS Board had concluded, in good faith, that its assumption of an average annual investment return of 8% was too conservative, and if it had decided, again in good faith, to increase its estimate of average annual investment returns, it could have afforded increased benefits without increasing the City's annual contribution. Alternatively, had the SDCERS Board chosen to recognize the erosion of the 8% investment return rate resulting from the Waterfall, it could have assumed a lower rate of return which would have increased the AAL and, in turn, the UAAL and the City's ARC. In either case, it should have been the SDCERS actuary who recommended the alteration of the assumption about long-term investment returns, and he should have done so, if at all, based on his best estimate of what these returns were likely to be in the future. In turn, the SDCERS Board should have accepted the actuary's recommendation without regard to the City's short-term budget needs.<sup>138</sup> As it was, the definition of Surplus Earnings allowed the City to conclude that it had found a pool of "surplus" money which, in a robust stock market, seemed almost limitless.

The precedent set by the 1980 legislation was a poor one. In subsequent years, the City turned with increasing frequency to Surplus Earnings to fund a succession of benefits that it did not have the political will to pay for directly.<sup>139</sup> This flow of Surplus Earnings to a succession of otherwise unfunded

---

<sup>136</sup> STEPHEN J. GAUTHIER, GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING: USING THE GASB 34 MODEL 715-16 (Government Finance Officers Association 2005); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1996, at 54 (Jan. 9, 1997).

<sup>137</sup> Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 10(f) (June 30, 2005).

<sup>138</sup> In fact, Mr. Roeder recommended that the Board lower the investment return assumption to account for the payment of certain contingent benefits, including the *Corbett* benefits. This advice was ignored. Minutes, SDCERS Business Procedures Committee at 4 (Feb. 16, 2001); Minutes, SDCERS Business Procedures Committee at 3-4 (Jan. 17, 2003); Minutes, SDCERS Business Procedures Committee at 4-5 (Feb. 21, 2003).

<sup>139</sup> See, e.g., Handwritten Notes of Cathy Lexin (Feb. 8, 2000); San Diego, Cal., Ordinance O-15758 (June 1, 1982). The funding of this succession of benefits is codified as San Diego Municipal Code § 24.1502, in which the order of these benefits is currently laid out as follows: (i) interest is credited to the contribution accounts of the Members, the



benefits came to be known as the “Waterfall.”<sup>140</sup> As long as the financial markets continued to deliver strong investment returns, the impact of the Waterfall on the financial health of SDCERS was neither transparent nor noticeable. But, the habit of raiding Surplus Earnings left SDCERS poorly positioned to weather inevitable financial hard times.

#### **D. Events Leading To MP-1**

In addition to the development of the “Waterfall,” several pre-1996 events appear, in retrospect, as red flags signaling SDCERS’s lack of proper independence from the City. In 1991, the City granted substantial new retirement benefits to employees, but made these additional benefits contingent on an agreement by SDCERS to change the cost method it used to estimate its AAL from Entry Age Normal (“EAN”) to Projected Unit Credit (“PUC”).<sup>141</sup> Although both EAN and PUC are cost methods accepted by the Governmental Accounting Standards Board (“GASB”), the two methods produce different results for the timing of required City contributions.<sup>142</sup> SDCERS adopted the change from EAN to PUC in 1991 primarily because the change was expected to lead to reduced annual payments by the City, at least in the short run,<sup>143</sup> and its agreement to make this change was a condition of the City’s granting new pension benefits to its employees.<sup>144</sup> As SDCERS Administrator Lawrence Grissom recorded, “[a]ll of these benefit changes are

---

City, and the Unified Port District at an interest rate determined by the Board; (ii) operating costs of SDCERS are paid; (iii) reserves are maintained at the discretion of the Board on the advice of its actuary; (iv) a proportional amount of Surplus Undistributed Earnings are credited to the Unified Port District; (v) post-retirement healthcare premiums are paid for the next fiscal year provided that in the next fiscal year the City contributes an equal amount into the 401(h) reserve and that this contribution is part of their normal employer contributions; (vi) the 13th Check is paid if there is more than \$100,000 available for the purpose (if there is not enough, this amount is rolled over into subsequent years until the rolled-over amount combined with the current year’s available funds exceed \$100,000); (vii) the contingent portion of the *Corbett* settlement is paid; and finally (viii) the Supplemental COLA is paid. In the event that there are Surplus Earnings remaining after the distribution listed above is completed, the remaining funds are credited to the Reserve for Employer Contributions for the sole and exclusive purpose of reducing the Retirement System liability.

<sup>140</sup> Minutes, SDCERS Special Board Meeting at 26 (May 29, 2002).

<sup>141</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991). In addition to adopting PUC to calculate its AAL, SDCERS also adopted PUC to calculate its normal cost, which is the actuarial present value of retirement system benefits allocated to the current year by the actuarial cost method. Gabriel, Roeder, Smith & Co., San Diego Employees’ Retirement System Annual Actuarial Valuation June 30, 1995, at 51 (Jan. 19, 1996).

<sup>142</sup> Under EAN, the actuarial present value of the projected benefits of each individual “is allocated on a level basis over the earnings or service of the individual between entry age and assumed exit age(s).” Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 40(B)(2) (June 30, 2005). Under PUC, the projected benefits are allocated by a consistent formula to valuation years. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 ¶ 40(B)(1) (June 30, 2005).

<sup>143</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991); Interview by the Audit Committee with Chuck Woolever (Apr. 20, 2006).

<sup>144</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991).

subject to Retirement Board approval of the conversion from the entry age normal to the projected unit credit method of actuarial valuation.”<sup>145</sup> At the same time, SDCERS extended the repayment period for the UAAL by instituting a new 30-year amortization period on July 1, 1991 (effective the subsequent year), which further reduced the City’s ARC.<sup>146</sup>

Either change might have been unobjectionable if it had reflected a good faith belief by SDCERS or its actuary that the newly-adopted method was more accurate or otherwise more appropriate than the old method. In each case, however, the change in fact seems to have been made solely or primarily to save the City money, an objective potentially inconsistent with the SDCERS Board’s mandate to safeguard the integrity of the pension system.<sup>147</sup> The change from EAN to PUC was an express condition to the City’s granting of new pension benefits.<sup>148</sup> This linkage compromised the SDCERS Board’s role in safeguarding the financial soundness of the pension system.<sup>149</sup>

In 1994, the City was experiencing “one of the worst economic cycles in its history,” and started discussing proposals with the SDCERS Board that dealt with alternative funding methods.<sup>150</sup> In addition, the SDCERS Board was about to approve the June 30, 1993 actuarial valuation that contained significant changes in the actuarial methodology, which would likely result in increased costs to the City. Before the SDCERS Board approved the actuarial valuation, City Manager Jack McGrory wrote a letter to the SDCERS Board requesting that the Board not approve the June 30, 1993 valuation until the City had time to review the “impact of increased costs to the General Fund as a result of the significant changes in the actuarial methodology.”<sup>151</sup>

By May 26, 1994, the City asked and the SDCERS Board approved the request to use approximately \$10 million of Surplus Earnings for a one-time reduction in the City’s annual pension

---

<sup>145</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991).

<sup>146</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 1997, at 42 (Jan. 16, 1998).

<sup>147</sup> Cal. Const. art. XVI, § 17.

<sup>148</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991).

<sup>149</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991).

<sup>150</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Business and Procedures Committee (May 6, 1994); Memorandum from Jack McGrory, City Manager, to City Employees Retirement System Board of Directors via Larry Grissom, Retirement Administrator (Feb. 17, 1994).

<sup>151</sup> Memorandum from Jack McGrory, City Manager, to City Employees Retirement System Board of Directors via Larry Grissom, Retirement Administrator (Feb. 17, 1994).

contribution.<sup>152</sup> SDCERS, with the approval of its actuary, Rick Roeder of Gabriel, Roeder, Smith & Company, agreed to do so if its outside fiduciary counsel, Morrison & Foerster, consented.<sup>153</sup> However, Morrison & Foerster concluded that permitting this diversion of accumulated “surplus” earnings without sufficient new “surplus” earnings being available that year would be inconsistent with the SDCERS Board’s fiduciary obligations, and the proposal died.<sup>154</sup> At the SDCERS Board meeting where Morrison & Foerster presented this negative opinion, some of the Board members suggested “getting a second outside opinion” and proposed a motion to have the City Attorney analyze the opinion provided by Morrison & Foerster.<sup>155</sup> This motion was not passed due in part to objections by some Board members that “[t]he fact that the Board does not like this answer is not justification to seek a second opinion.”<sup>156</sup> Ominously, however, Morrison & Foerster was abruptly replaced as fiduciary counsel, ostensibly for failing to provide legal advice quickly enough, shortly before the SDCERS Board took up the even more controversial MP-1 proposal.<sup>157</sup> If the legal reasoning that Morrison & Foerster applied to the 1994 proposal had been applied to MP-1, MP-1 would have been found to be improper.

These events show a disturbing tendency for the City to pressure SDCERS to grant contribution relief without regard to the impact this relief might have on the financial soundness of the pension system.<sup>158</sup> They also show the City attempting to make SDCERS share political responsibility for the benefits granted to – or withheld from – City employees, even though this responsibility should have been borne exclusively by the City.

In the years leading up to 1996, a series of events put a particularly severe strain on the City’s ability to satisfy its ongoing annual payment obligations to SDCERS. First, SDCERS had recently completed a review of actuarial assumptions underlying its calculation of future retirement obligations and began using

---

<sup>152</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Retirement Board (Mar. 16, 1995).

<sup>153</sup> Draft Memorandum of Understanding between the City of San Diego and the Retirement Board of Administration (June 17, 1994); Memorandum from Lawrence B. Grissom, Retirement Administrator, to Retirement Board (Mar. 16, 1995).

<sup>154</sup> Letter from Morrison & Foerster to Lawrence B. Grissom, Retirement Administrator (May 9, 1995).

<sup>155</sup> Minutes, SDCERS Board Meeting at 14-15 (May 19, 1995).

<sup>156</sup> Minutes, SDCERS Board Meeting at 14-15 (May 19, 1995).

<sup>157</sup> Minutes, SDCERS Board Special Meeting at 3 (May 2, 1996); Minutes, SDCERS Board Meeting at 13 (May 15, 1996). The “Board had been dissatisfied with the timeliness of receiving legal opinions from that firm and their lack of responsiveness to this Board.” Minutes, SDCERS Special Board Meeting at 3 (May 2, 1996).

<sup>158</sup> This tendency is supported by interviews conducted by Navigant Consulting, Inc. Interview by Navigant Consulting, Inc., with Lawrence Grissom (Dec. 14, 2005); Interview by Navigant Consulting, Inc., with Keith Enerson (Dec. 2, 2005).

new and revised assumptions.<sup>159</sup> The review included an updating of demographic assumptions about the City's work force, such as the average retirement age of the City's employees and the average number of additional years of service before retirement.<sup>160</sup> The new and revised assumptions were expected to increase both the City's cost of funding new retirement obligations arising out of each year of continuing employee service and the City's AAL.<sup>161</sup> Both of these effects were expected to increase the City's ARC.<sup>162</sup>

Second, the City faced negotiations with its unions in 1996 and agreed to significant improvements in retirement benefits as part of the negotiation process.<sup>163</sup> These negotiations produced a sharp, retroactive increase in basic retirement benefits for each year of service for general members.<sup>164</sup>

At the same time that these events created the expectation of a significant increase in the City's annual contribution to SDCERS, the City's budget was otherwise under considerable strain.<sup>165</sup> In particular, the City's costly hosting of the 1996 Republican National Convention made belt-tightening in other areas desirable.<sup>166</sup>

The events leading to MP-1 cannot properly be characterized as a crisis. Certainly the City's budget was under pressure in 1995 and 1996, but it was often under pressure.<sup>167</sup> The City faced significant increases in spending for retirement benefits, but these potential increases were only a small fraction of the City's total budget. And San Diego, compared with other cities of comparable size and complexity, has not

---

<sup>159</sup> Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 1994, at 14, 46-48 (Mar. 6, 1995).

<sup>160</sup> Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 1994, at 14, 46-48 (Mar. 6, 1995).

<sup>161</sup> Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 1994, at 9, 14 (Mar. 6, 1995).

<sup>162</sup> Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 1994, at 14 (Mar. 6, 1995).

<sup>163</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 7.

<sup>164</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 7.

<sup>165</sup> Philip J. LaVelle, *A Major-League Player*, San Diego Union-Tribune, June 18, 2006, available at [http://www.signonsandiego.com/uniontrib/20060618/news\\_mz1n18labor.html](http://www.signonsandiego.com/uniontrib/20060618/news_mz1n18labor.html).

<sup>166</sup> Philip J. LaVelle, *A Major-League Player*, San Diego Union-Tribune, June 18, 2006, available at [http://www.signonsandiego.com/uniontrib/20060618/news\\_mz1n18labor.html](http://www.signonsandiego.com/uniontrib/20060618/news_mz1n18labor.html).

<sup>167</sup> For example, in 1994, City Manager Jack McGrory stated: "I am sure that you are all well aware of the fact that the City is currently experiencing one of the worst economic cycles in its history. The economic downturn is creating a devastating affect [sic] on the City's General Fund expenditure capabilities which includes the City's contributions to CERS." Memorandum from Jack McGrory, City Manager, to City Employees Retirement System Board of Directors via Larry Grissom, Retirement Administrator (Feb. 17, 1994).

historically been burdened with unusually high local taxes.<sup>168</sup> While special circumstances may help to *explain* MP-1, they do not *justify* it or make it inevitable.

### E. Manager's Proposal 1

The City's response to the events of 1995 and early 1996 was MP-1.<sup>169</sup> Under MP-1, the City, in its negotiations with its principal unions, agreed to significantly enhance retirement benefits, including a retroactive increase in the percentage used to calculate basic pension benefits.<sup>170</sup> These benefits, however, would go into effect if, but only if, SDCERS agreed to a plan under which the City would make annual payments according to a fixed formula of slowly increasing percentages of total payroll *instead of* the ARC calculated each year by the SDCERS actuary.<sup>171</sup> Under MP-1, the City would make payments based on the City's budgeted rates for FY 1996 and FY 1997 which were not updated for the current changes in actuarial assumptions and benefit increases.<sup>172</sup> Thereafter, through 2006, the City would contribute to SDCERS a gradually increasing percentage of payroll that remained below the actuarially-calculated amount.<sup>173</sup> In 2007, the City's contribution was projected to reach the ARC and the City and SDCERS would then revert to the original system under which the City would pay the full ARC each year.<sup>174</sup>

---

<sup>168</sup> Center on Policy Initiatives, *The Bottom Line: Solutions for San Diego's Budget Crisis* at i-iii (Apr. 2005).

<sup>169</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal); Interview by the Audit Committee with John Kaheny (May 11, 2006); Interview by the Audit Committee with Jack McGrory (May 4, 2006).

<sup>170</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal).

<sup>171</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal); *see also* Letter from Jeffrey S. Leavitt to Bruce A. Herring, Deputy City Manager (Apr. 29, 1996). During depositions taken in connection with *Gleason v. San Diego Employees' Retirement System*, Board member John Torres and Cathy Lexin agreed that the City conditioned enhanced retirement benefits on the SDCERS Board's approval of MP-1. Ms. Lexin further agreed at her deposition that some of the enhanced retirement benefits affected members of the SDCERS Board. Defendants San Diego City Attorney Michael J. Aguirre and the City of San Diego's Notice of Lodgment in Support of Its Motion for Summary Judgment or Alternatively, Summary Adjudication, *San Diego City Employees' Ret. Sys. v. Aguirre*, No. GIC 841845 (Cal. Super. Ct. Jan. 27, 2005) (attaching the partial deposition transcripts of John Torres (Jan. 27, 2004), and Cathy Lexin (Jan. 30, 2004) (*Gleason v. San Diego City Employees' Ret. Sys.*, No. GIC 803779 (Cal. Super. Ct. Jan 16., 2003))).

<sup>172</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 6.

<sup>173</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 6.

<sup>174</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 6.

Moreover, the ARC payment that the City would begin making in FY 2007 would be based on a return to the EAN cost method, which SDCERS had abandoned in 1991 in order to save the City money.<sup>175</sup>

The immediate impact of MP-1 was to allow the City to avoid, in FY 1997, the contribution increases that otherwise would have been required beginning in 1996 both by the adoption of revised actuarial assumptions and by the new retirement benefits that went into effect at the beginning of FY 1997.<sup>176</sup> In future years, the City would continue to benefit to the extent that its stepped-up increases in payments lagged behind the combined cost of the new actuarial assumptions and the newly-granted retirement enhancements. Unfortunately, the cost would be passed on to a future generation of taxpayers. Finally, MP-1 made no provision for the funding of any additional benefit increases that might be granted by, or imposed upon, the City during MP-1's term. To be sure, nothing in MP-1 prevented the City from increasing its annual contributions to SDCERS to cover the costs of additional benefits, but, under MP-1, it was the City, not SDCERS, that controlled this decision, because SDCERS had agreed to accept the funding levels specified by MP-1.<sup>177</sup>

All participants in the adoption of MP-1 understood the proposal would result in lower payments by the City throughout the term of the agreement than it otherwise would have been required to make.<sup>178</sup> This payment holiday was intended to be funded by the Surplus Earnings account at SDCERS,

---

<sup>175</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 6. Notably, Retirement Administrator Lawrence Grissom – and, more than likely, some City officials – understood that while the PUC cost method adopted by the City in 1991 generated lower required contributions for the City in the short-term than EAN, PUC would eventually be more costly to the City. Indeed, during the initial stages of formulating MP-1, Mr. Grissom recognized that, “[i]f things keep going the way they have been, the lines [of PUC and EAN] will cross in the next 2 to 5 years, *less than 10 years after implementation*. At the end of the amortization period, PUC could logically be very significantly higher.” Memorandum from Larry Grissom to Keith Enerson (Draft Mar. 1, 1996) (emphasis in original).

<sup>176</sup> Letter from Rick A. Roeder to Larry Grissom (June 13, 1996); Gabriel, Roeder, Smith & Co., San Diego Employees’ Retirement System Annual Actuarial Valuation June 30, 1994 (Mar. 6, 1995).

<sup>177</sup> Minutes, SDCERS Board Meeting at 31 (June 21, 1996). Former City Manager Jack McGrory, who proposed MP-1, was emphatic that he never intended new retirement benefits to be added without new funding sources being provided as well, and that he was dismayed when, after his departure as City Manager, benefits were added without any additional funding (as a result of a litigation known as *Corbett*, to be discussed in further detail below). Interview by the Audit Committee with Jack McGrory (May 4, 2006). Mr. McGrory’s assertion is difficult to credit given the language of MP-1. If Mr. McGrory intended to condition the granting of future retirement benefits upon commensurate increased funding of SDCERS, he could have. MP-1 contains no such conditions. Even crediting this statement of Mr. McGrory’s good intentions, however, it remains the case that MP-1 both intentionally allowed the City to pay less than its Annual Required Contribution during the life of the agreement and took the right to adjust the City’s contribution rate out of the hands of SDCERS and its actuary, where it belonged, and gave it to the City.

<sup>178</sup> Minutes, SDCERS Board Meeting at 16 (June 21, 1996); Minutes, San Diego City Council Meeting at 21-22 (July 2, 1996).

which would be drawn down over the life of MP-1.<sup>179</sup> But, as discussed above, the Surplus Earnings were not really “surplus.” Even taking them into account, SDCERS was *already* not fully funded in 1996, with a funded ratio before MP-1 of 93.5%.<sup>180</sup> The SDCERS UAAL for FY 1995, which was released on January 19, 1996, was \$96.3 million.<sup>181</sup>

To protect SDCERS from too drastic an erosion of its financial strength, MP-1 included a safety valve provision: if the SDCERS funded ratio – the ratio of its AVA to its AAL – dropped by 10% from its 1996 level, the MP-1 funding agreement would terminate and the City would be required to make increased payments to bring the SDCERS funded ratio up to a required floor of 82.3% of liabilities, or 10% below its 1996 funded level.<sup>182</sup>

By its terms, MP-1 required the City, in the event the funded ratio was breached, to make a one-time, balloon payment to SDCERS to restore the required funded ratio.<sup>183</sup> In 2002, when it became apparent that the funded ratio floor had been, or soon would be, breached, and that the payment needed to restore the required funded ratio would be painfully large, various responsible decision-makers purported to find it “ambiguous” whether MP-1 required a large onerous balloon payment or whether the restoration of the funded floor could be phased in over time.<sup>184</sup> We find no evidence of any such “ambiguity” in 1996. By its terms, the MP-1 agreement required a balloon payment, and the City appears to have recognized this requirement at the time MP-1 was enacted.<sup>185</sup> The record leading up to the SDCERS adoption of MP-1 indicates that SDCERS expected immediate action to restore the necessary funded ratio if the floor were breached.<sup>186</sup> At the SDCERS Board meeting on June 21, 1996, at which MP-1 was approved, several Board

---

<sup>179</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 8.

<sup>180</sup> Gabriel, Roeder, Smith & Co., San Diego Employees’ Retirement System Annual Actuarial Valuation June 30, 1995, at 13 (Jan. 19, 1996).

<sup>181</sup> Gabriel, Roeder, Smith & Co., San Diego Employees’ Retirement System Annual Actuarial Valuation June 30, 1995, at 13 (Jan. 19, 1996).

<sup>182</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 7; Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 1996, at 16 (Jan. 9, 1997).

<sup>183</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 7.

<sup>184</sup> Minutes, SDCERS Board Meeting at 7 (July 11, 2002).

<sup>185</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 7; Minutes, SDCERS Board Meeting at 22-23 (June 21, 1996).

<sup>186</sup> Minutes, SDCERS Board Meeting at 15, 22-23 (June 21, 1996); Minutes, SDCERS’ Retirement Board of Administration Special Workshop at 19 (June 11, 1996); Memorandum from Larry Grissom, Retirement Administrator, to Cathy Lexin, Labor Relations Manager (July 23, 1996).

members specifically raised the issue of whether MP-1 might create a situation in which the City would be required to make a large, one-time payment that it would not be able to make.<sup>187</sup> City Manager McGrory acknowledged that this was a risk, but countered that because a one-time balloon payment would be so burdensome, the City would not allow the floor to be breached and would voluntarily increase its contributions well in advance of such an event in order to prevent it from happening.<sup>188</sup>

In short, both SDCERS and the City understood in 1996 that a breach of the 82.3% funding floor would trigger a lump-sum payment obligation from the City in the next fiscal year in an amount sufficient to restore the funded ratio to its floor. The City pledged to avoid this crisis by increasing its contributions voluntarily to ensure the 82.3% floor was not breached. The City failed to do so, then argued in 2002 that, because MP-1 was “ambiguous,” it should be granted time to “phase in” the restoration of the funding floor.<sup>189</sup>

In any event, the City was sufficiently concerned that it would eventually hit the funded floor trigger that it insisted that new actuarial assumptions be used to calculate the funded base from which the 10% decline would be calculated.<sup>190</sup> It was also insistent that all costs, including a benefit known as the 13th Check<sup>191</sup> and healthcare benefits, be included in the funded base (such that the trigger would be based on a lower number) and suggested that no analysis of actuarial assumptions be performed until at least 1999.<sup>192</sup> These protections were needed, Deputy Auditor and Comptroller Terri Webster explained to City Manager McGrory, “to give as much breathing room from the 10% deal breaker.”<sup>193</sup> Using the new assumptions, and including all relevant liabilities, SDCERS recalculated its 1996 funded ratio as 92.3%.<sup>194</sup>

---

<sup>187</sup> Minutes, SDCERS Board Meeting at 15, 22 (June 21, 1996).

<sup>188</sup> Minutes, SDCERS Board Meeting at 22, 23 (June 21, 1996).

<sup>189</sup> Minutes, SDCERS Board Meeting at 7-13 (July 11, 2002); Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Honorable Mayor and City Council (July 8, 2002).

<sup>190</sup> E-mail from Terri Webster to Jack McGrory (June 21, 1996).

<sup>191</sup> The 13th Check is a contingent benefit that is distributed each year to eligible retirees if SDCERS “has realized sufficient surplus undistributed earnings from the previous fiscal year.”

<sup>192</sup> E-mail from Terri Webster to Jack McGrory (June 21, 1996).

<sup>193</sup> E-mail from Terri Webster to Jack McGrory (June 21, 1996).

<sup>194</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 1996, at 16 (Jan. 9, 1997).



The safety valve provision of MP-1 would therefore be triggered if the SDCERS funded ratio fell below 82.3%.<sup>195</sup>

Significantly, SDCERS actuary Rick Roeder predicted – accurately – that SDCERS’s funded ratio would fall below the 82.3 % trigger in five to six years.<sup>196</sup> This prediction underscores the fact that City and SDCERS decision-makers were fully aware MP-1 would have the effect of reducing the City’s annual payments below what they otherwise would have been and that this reduction would erode the SDCERS funded ratio.

MP-1’s express linkage between increased benefits for City employees and retirement payment relief for the City placed pressure on the SDCERS Board.<sup>197</sup> The conflict must have been particularly acute for the union representatives on the Board, whose union constituents would not be granted important new benefits unless the Board agreed to reduce the City’s obligation to fund these (and pre-existing) benefits.<sup>198</sup> City officials on the SDCERS Board faced a similar conflict. As part of the City’s management team, they were under pressure to balance the budget while reaching agreement with the unions. Ms. Webster, for example, reported to City Manager McGrory on changes needed to MP-1 from “our” (*i.e.*, the City’s) perspective, even though she also sat on the SDCERS Board.<sup>199</sup> These pressures conflicted with their obligations as Board members to protect the financial stability and integrity of SDCERS.

With some degree of difficulty, the City and SDCERS obtained the acquiescence of the outside advisers – counsel for both SDCERS and the City and the SDCERS actuary – in the legality of MP-1.<sup>200</sup> Significantly, the SDCERS fiduciary counsel was a new law firm, Hamilton and Faatz of Denver, Colorado, brought in to replace Morrison & Forester, which only one year earlier had given unwanted cautionary advice to the SDCERS Board.<sup>201</sup> If the same legal analysis had been applied to MP-1, fiduciary

---

<sup>195</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 7.

<sup>196</sup> Minutes, SDCERS’ Retirement Board of Administration Special Workshop at 14 (June 11, 1996).

<sup>197</sup> Minutes, SDCERS Board Meeting at 16, 20 (June 21, 1996); Minutes, SDCERS’ Retirement Board of Administration Special Workshop at 21-23 (June 11, 1996).

<sup>198</sup> Union representatives who were not members of the Board lobbied for the acceptance of this agreement. Minutes, SDCERS Board Meeting at 30 (June 21, 1996).

<sup>199</sup> E-mail from Terri Webster to Jack McGrory (June 21, 1996).

<sup>200</sup> Minutes, SDCERS Board Meeting (June 21, 1996); Letter from Dwight Alan Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence B. Grissom, Retirement Administrator (June 21, 1996). Letter from Jeffrey S. Leavitt to Jack McGrory, City Manager (Draft “July \_\_, 1996”); Letter from Jeffrey S. Leavitt to Bruce A. Herring, Deputy City Manager (Draft “June \_\_, 1996”).

<sup>201</sup> Letter from Morrison & Foerster to Lawrence B. Grisson, Retirement Administrator (May 9, 1995).

counsel would have found it improper. On the City side, City Attorney John Witt declined to address the legality of MP-1, citing a potential conflict of interest because MP-1 would increase his personal retirement benefits, and urged the City to get independent legal advice.<sup>202</sup> Mr. Witt had warned of the danger of SDCERS's assuming any role in the conferring of benefits in the past,<sup>203</sup> and his letter recusing himself specifically noted that MP-1 "raises important fiduciary considerations."<sup>204</sup> Thus the legal advisors to both the City and SDCERS were brand new, and in each case they replaced legal advisers whose track record suggested considerable skepticism about MP-1.

As discussed more fully below, the professionals who gave their blessing to MP-1 were wrong. There is no evidence that any of them even considered the question of whether MP-1 was permissible under the California Constitution, the San Diego Municipal Code ("Municipal Code"), or California case law<sup>205</sup> – we conclude that it was not – and their analysis of the fiduciary duty and conflicts issues was superficial.<sup>206</sup> Beyond these mistakes, the outside professionals never concluded affirmatively that MP-1 was proper, they merely concluded that an affirmative finding *by the SDCERS Board* that MP-1 was in the best interests of SDCERS beneficiaries would not be a violation of the Board's fiduciary duty. There is no evidence that the SDCERS Board in fact ever made such a finding. It is one thing to conclude, as the outside professionals did, that MP-1 was not obviously illegal and improper. The SDCERS Board, however, was not allowed to stop there. To fulfill its fiduciary responsibility, it was required to find that MP-1 was in the interests, or at least not contrary to the interests, of SDCERS beneficiaries. The Board did not make this finding, and, as discussed below, it could not properly have done so on the record it had.

MP-1 was, quite simply, an improper agreement by the City and the SDCERS Board to grant immediate benefits while making no corresponding provision for paying for them.

## **F. The Aftermath of MP-1**

One of the important new benefits that the City granted employees in 1996, contingent on SDCERS's adoption of MP-1, was an enhanced Purchase of Service Credit ("PSC") benefit, under which

---

<sup>202</sup> John W. Witt, City Attorney, Report to the Board of Administration for the San Diego City Employees' Retirement System (Apr. 23, 1996). The same "potential conflict" confronting City Attorney Witt (namely, the increase in his personal retirement benefits) was also facing the City employees on the SDCERS Board.

<sup>203</sup> Memorandum from John W. Witt, City Attorney, to Larry B. Grissom, Retirement Administrator (Mar. 10, 1992).

<sup>204</sup> John W. Witt, City Attorney, Report to the Board of Administration for the San Diego City Employees' Retirement System (Apr. 23, 1996).

<sup>205</sup> Letter from Jeffrey S. Leavitt to Jack McGrory, City Manager (Draft "July \_\_, 1996").

<sup>206</sup> See Section V: Parties Responsible for Violations of Law: Pension.

employees could “purchase” years of service so as to increase the amount of their pension upon retirement.<sup>207</sup> PSC units were supposed to be priced at cost and fully paid for by the employee, so that the benefit enhancement purchased would be fully funded by the purchase price and there would be no cost to the City, including no net increase in the City’s UAAL.<sup>208</sup>

PSC-like programs are common in municipal retirement programs.<sup>209</sup> Although they attempt to be generally cost-neutral, they frequently are not.<sup>210</sup> One of the most common causes of mispricing, a problem that clearly afflicted the SDCERS PSC benefit, is that years of service are often priced at a flat rate that is essentially an “average cost” for an entire group of employees.<sup>211</sup> This pricing method ignores using age to calculate the true cost for a year of service credit and significantly subsidizes PSC purchases by older employees.<sup>212</sup> Not surprisingly, young workers rarely take advantage of the program, while workers near retirement find it extremely attractive.<sup>213</sup>

This is exactly what happened in San Diego’s case. Older workers took advantage of the PSC benefit; younger workers generally did not; and the result was that a supposedly cost-neutral benefit in fact added millions of dollars to SDCERS’s total liabilities.<sup>214</sup> Furthermore, as benefits were increased by the City, neither was the price of PSCs increased nor were employees required to make additional payments to cover the added cost to the system.<sup>215</sup> When the SDCERS actuary finally received the data necessary to quantify the total liability for the underpricing of the PSC program as of June 30, 2002, he found that City

---

<sup>207</sup> E-mail from Cathy Lexin to Dennis Gibson (Sept. 28, 2004).

<sup>208</sup> Minutes, SDCERS’ Retirement Board of Administration Special Workshop at 3 (June 11, 1996); Memorandum from Cathy Lexin to Dennis Gibson (Oct. 7, 2004).

<sup>209</sup> See, e.g., [http://www.in.gov/perf/public/additional\\_service.html](http://www.in.gov/perf/public/additional_service.html); <http://www.smc.edu/personnelcommission/news.htm>

<sup>210</sup> See, e.g., Texas Retired Teachers Association, Legislative Update No. 12, <http://www.trta.org/viewUpdate.cfm?updateNo=12> (Apr. 22, 2005); Contra Costa County Grand Jury Report No. 0409 at 6 (Mar. 2004).

<sup>211</sup> Letter from Rick A. Roeder to Larry Grissom (Mar. 3, 1997).

<sup>212</sup> Letter from Rick A. Roeder to Service Purchase Task Force (Feb. 19, 2002).

<sup>213</sup> E-mail from Paul Barnett to Rick Roeder (July 18, 2003); Letter from Rick A. Roeder to Service Purchase Task Force (Feb. 19, 2002).

<sup>214</sup> E-mail from Paul Barnett to Rick Roeder (July 18, 2003); E-mail from Rick Roeder to Terri Webster (Aug. 14, 2003).

<sup>215</sup> Minutes, SDCERS Business Procedures Committee at 7 (May 24, 2002); Interview by Vinson & Elkins with Rick Roeder (June 2, 2004).

employees had purchased credits entitling them to additional retirement benefits estimated at \$77.7 million.<sup>216</sup> The unfunded portion of this liability caused a 2% reduction in the funded ratio.<sup>217</sup> The actuary later estimated that the price SDCERS charged employees for PSCs only covered approximately 50% of the costs with the City theoretically picking up the remaining cost through increased contributions.<sup>218</sup> SDCERS simply absorbed new unfunded liabilities for PSCs which impacted the unfunded liability by more than \$56.4 million between the 2001 and 2002 actuarial valuations.<sup>219</sup> Even this number may have been understated.<sup>220</sup>

The pricing mistake was clearly apparent to the SDCERS Board by at least February 2002.<sup>221</sup> Despite this fact, the Board failed to act over the next two years, even waiting eight months after learning the increase in unfunded liability due to the PSCs was well into the millions of dollars.<sup>222</sup> Upon finally adjusting the price in 2003, the SDCERS Board still failed to include age in the pricing methodology<sup>223</sup> and inexplicably provided an advance notice of over two months to employees of the impending price change.<sup>224</sup>

---

<sup>216</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 17 (Jan. 9, 2003).

<sup>217</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 17 (Jan. 9, 2003).

<sup>218</sup> Minutes, SDCERS Business Procedures Committee at 5 (Aug. 15, 2003); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 17 (Jan. 9, 2003).

<sup>219</sup> Minutes, SDCERS Business Procedures Committee at 4-5 (Aug. 15, 2003); E-mail from Rick Roeder to Terri Webster (Aug. 14, 2003); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 10, 14 (Jan. 9, 2003).

<sup>220</sup> E-mail from Rick Roeder to Terri Webster (Aug. 14, 2003); Minutes, SDCERS Business Procedures Committee at 4 (Aug. 15, 2003).

<sup>221</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 17 (Feb. 12, 2002); Letter from Rick A. Roeder to Service Purchase Task Force (Feb. 19, 2002).

<sup>222</sup> E-mail from John Kern to Terri Webster, Bill Baber and Dennis Gibson (Feb. 10, 2003); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 10, 14 (Jan. 9, 2003); Minutes, SDCERS Business Procedures Committee Meeting at 5-6 (Aug. 16, 2002); Minutes, SDCERS Business Procedures Committee Meeting at 7 (May 24, 2002).

<sup>223</sup> Mercer Human Resources Consulting, Audit of Actuarial Work, San Diego City Employees' Retirement System at 3 (May 11, 2004); Minutes, SDCERS Board Meeting at 20-23 (Aug. 15, 2003); Memorandum from Paul Barnett, Assistant Retirement Administrator via Lawrence B. Grissom, Retirement Administrator, to Retirement Board via Business Procedures Committee (Aug. 6, 2003).

<sup>224</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2004, at vR (Jan. 14, 2005). It appears that Terri Webster attempted to get the Board to change the pricing of PSCs. However, she later actually encouraged employees to take advantage of the pricing discrepancy, knowing the Board was about to raise the cost to purchase PSCs. E-mail from Terri Webster to Auditor & Comptroller's Office (Aug. 12, 2003).

Moreover, even some City Council members, such as Toni Atkins and Ralph Inzunza, took advantage of the under-priced PSCs, purchasing "air time" after February 2002. Interview by the Audit Committee with Toni Atkins (Apr. 28, 2006); E-mail from Paul Barnett to Loraine Chapin cc to Lawrence Grissom (Apr. 2, 2003).

The advance notice gave thousands of employees the additional benefit of buying PSCs at the lower cost, further increasing the unfunded liabilities attributable to the PSC program.<sup>225</sup>

### **G. Post-Retirement Healthcare**

The City of San Diego has provided healthcare benefits to retirees since the early 1980s, when the City left the Social Security system.<sup>226</sup> Retiree healthcare benefits were paid directly out of the pension system's Surplus Earnings from fiscal year 1983 through fiscal year 1992, with the benefit being added to the "Waterfall" in 1985.<sup>227</sup> The City later amended the Municipal Code to clarify that retiree healthcare would come out of the General Fund if Surplus Earnings from the pension system were insufficient to cover the benefit.<sup>228</sup> During this period, approximately \$8.2 million was transferred from the SDCERS Trust to pay for post-retiree healthcare premiums.<sup>229</sup>

In 1992, a determination was made that the funding of retiree healthcare premiums out of pension assets may have violated federal tax laws.<sup>230</sup> In order to comply with these laws, the City needed to develop a new system in which pension assets were not used to pay for retiree healthcare, which is a non-pension-related benefit. Accordingly, the City chose a less conspicuous way to divert assets from the SDCERS Trust, instituting a new system of "bifurcated payments."<sup>231</sup> Each year, the City would make its required contribution into the pension system as calculated by the SDCERS actuary and mandated by the City Charter and Municipal Code, less the estimated cost of retiree healthcare premiums for the coming

---

<sup>225</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation Fiscal Year Ended June 30, 2003, at 10 (Jan. 8, 2004); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation Fiscal Year Ended June 30, 2004, at vR (Jan. 14, 2005); Notes from Cathy Lexin on Purchase of Service Credit Benefit (Dec. 31, 2003).

<sup>226</sup> San Diego, Cal., Ordinance O-15758 (June 1, 1982); San Diego City Council Resolution R-255610 (Jan. 4, 1982).

<sup>227</sup> Ice Miller LLC, Presentation on IRS Filing with respect to Retiree Health Funding and Administrative Expenses (presented to Navigant Report Committee) (June 14, 2006); San Diego, Cal., Ordinance O-16449 (June 24, 1985).

<sup>228</sup> San Diego, Cal., Ordinance O-16510 (Sept. 30, 1985).

<sup>229</sup> Ice Miller LLC, Presentation on IRS Filing with respect to Retiree Health Funding and Administrative Expenses (presented to Navigant Report Committee) (June 14, 2006).

<sup>230</sup> San Diego, Cal., Ordinance O-17770 (May 26, 1992); Letter from Lawrence B. Grissom, Retirement Administrator, to Hufstедler & Kaus, Attention: Mike Toumanoff (June 3, 1994). Lawrence Grissom and Robert Blum (SDCERS's tax advisor at the time) were aware as early as 1990 that retiree healthcare could not be paid for out of SDCERS Surplus Earnings. Memorandum from Larry Grissom to Keith Enerson (Feb. 26, 1996).

<sup>231</sup> E-mail from Lawrence Grissom to Terri Webster cc to Cathy Lexin and Cecilia San Pedro (Mar. 3, 2003); Memorandum from Larry Grissom to Keith Enerson (Feb. 26, 1996); Letter from Morrison & Foerster to Lawrence B. Grissom, Retirement Administrator (Aug. 22, 1995).

year.<sup>232</sup> At the end of the year, Surplus Earnings would be used (to the extent then available) to credit the Employer Contribution Reserve in the amount of the retiree healthcare premiums estimate, offsetting the City's contribution shortfall.<sup>233</sup> As a vehicle for this bifurcated payment plan, the City created a Retiree Health Insurance Trust Fund ("RHITF"), funded by City contributions, to comply with the requirements of Internal Revenue Code ("IRC") Section 401(h).<sup>234</sup> From fiscal year 1993 through fiscal year 1997, the post-retirement healthcare benefit was funded – as a technical matter and aside from the subsequent credit from SDCERS Surplus Earnings that the City took for its pension contribution shortfall to the SDCERS Trust – by the City's contributions to the RHITF and the subsequent investment earnings from those contributions.<sup>235</sup>

In August 1995, however, SDCERS's outside counsel determined that this approach was also legally problematic as it violated constitutional and statutory trust obligations that govern the use of surplus earnings, continued to fund a non-pension-related benefit from pension assets, and diminished the City's contribution below the ARC.<sup>236</sup> As part of MP-1, and seemingly in response to the August 1995 legal opinion, the City proposed making retiree health insurance a SDCERS benefit.<sup>237</sup> Responsibility for retiree healthcare was transferred from the City to SDCERS by an amendment to the City Charter, Proposition D, which passed in November 1996.<sup>238</sup> The City Manager had promoted Proposition D as a cost saving measure.<sup>239</sup>

---

<sup>232</sup> Memorandum from Larry Grissom to Keith Enerson (Feb. 26, 1996); Letter from Lawrence B. Grissom, Retirement Administrator, to Hufstedler & Kaus, Attention: Mike Toumanoff (June 3, 1994).

<sup>233</sup> Memorandum from Larry Grissom to Keith Enerson (Feb. 26, 1996); Letter from Lawrence B. Grissom, Retirement Administrator, to Hufstedler & Kaus, Attention: Mike Toumanoff (June 3, 1994).

<sup>234</sup> San Diego, Cal., Ordinance O-17770 (May 26, 1992). The ordinance deleted retiree healthcare payments from the Waterfall. While the ordinance laid out a number of the requirements of IRC Section 401(h) – with which the RHITF would need to comply – it is questionable whether the IRS would find that the RHITF was in fact a 401(h) account, as it was administered by the City outside of the System between 1992 and 1997. The Ice Miller law firm (SDCERS's tax counsel) has advanced that the RHITF was "arguably a valid 401(h) account." Ice Miller LLC, Presentation on IRS Filing with respect to Retiree Health Funding and Administrative Expenses (presented to Navigant Report Committee) at 10 (June 14, 2006).

<sup>235</sup> The City paid \$25.3 million into the RHITF in the first two years after its creation. The investment returns on this contribution generated a sufficient surplus, along with the principal, to fund the retiree healthcare benefit through fiscal year 1997. Ice Miller LLC, Presentation on IRS Filing with respect to Retiree Health Funding and Administrative Expenses (presented to Navigant Report Committee) at 6-7 (June 14, 2006).

<sup>236</sup> Letter from Morrison & Foerster to Lawrence B. Grissom, Retirement Administrator (Aug. 22, 1995); Minutes, SDCERS Board Meeting at 12-13 (Aug. 25, 1995).

<sup>237</sup> City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) at 1; Concept Overview, City Employees Retirement System (May 2, 1996); Memorandum from Larry Grissom to Keith Enerson (Mar. 1, 1996).

<sup>238</sup> San Diego City Council Resolution R-288173 (Dec. 9, 1996). The amendment to the City Charter was a prerequisite to the re-positioning of the retiree healthcare benefit trust within SDCERS. Letter from Dwight Alan

In order to transition the retiree healthcare benefit from the City to SDCERS, the City established a separate trust account within SDCERS, pursuant to IRC Section 401(h), to be used for funding retirement healthcare benefits.<sup>240</sup> The City would deposit funds covering the estimated cost of retiree health insurance premiums for a given year (plus additional reserve amounts) into this 401(h) account, and SDCERS would then transfer an identical amount back to the City from its Surplus Earnings.<sup>241</sup> Notably, retiree healthcare was added back into the Waterfall, such that if Surplus Earnings were not available in any given year to make this transfer, the funding shortfall would come out of the City's General Fund.<sup>242</sup> This system, which was approved by SDCERS's tax advisor, Robert Blum, allowed the City to recover the cost of the benefit and was set up in this manner in an attempt to maintain compliance with the IRC by avoiding direct payment of a non-pension-related benefit from SDCERS assets.<sup>243</sup> This payment mechanism also allowed the City to continue to avoid paying for retiree health insurance premiums by reclassifying them as a SDCERS benefit rather than a City benefit. Health insurance premiums continued to be funded, albeit indirectly, out of pension system assets, a fact City officials continued to obfuscate.<sup>244</sup>

Beginning in FY 1998, the City made contributions to SDCERS that were treated as pension contributions but were immediately used in part to satisfy the payment of retiree healthcare benefits.<sup>245</sup> As a result, the City, which was already paying less than the ARC into the pension system under MP-1, was in reality paying even less than the contracted rate and toward its UAAL. A portion of that

---

Hamilton, Hamilton and Faatz, and John A. Graham, Frandzel & Share, to Lawrence Grissom, Retirement Administrator (June 21, 1996); Minutes, SDCERS Board Meeting at 18 (June 21, 1996).

<sup>239</sup> According to City Manager Jack McGrory, Proposition D "relieves from our operating budgets the obligation to pay approximately \$6 million a year for health benefits for retirees." Philip J. LaVelle, *Shift in Health Benefit Sought*, San Diego Union-Tribune, Oct. 18, 1996, at B4.

<sup>240</sup> San Diego, Cal., Ordinance O-18383 (Feb. 25, 1997); San Diego Municipal Code § 24.1203.

<sup>241</sup> San Diego, Cal., Ordinance O-18383 (Feb. 25, 1997); San Diego Municipal Code §§ 24.1203(b), 24.1502(a)(5).

<sup>242</sup> San Diego, Cal., Ordinance O-18383 (Feb. 25, 1997); San Diego Municipal Code § 24.1502(a)(5).

<sup>243</sup> Letter from Bob Blum, William M. Mercer, Inc., to Lawrence Grissom, Retirement Administrator (Mar. 13, 2000).

<sup>244</sup> In editing Cathy Lexin's initial draft of the ballot argument in favor of Proposition D, which transferred the administration of retiree healthcare from the City to SDCERS, Lawrence Grissom sought to conceal from the voters the ultimate reserve for the City's "savings" generated by the proposed amendment: "I deleted the sentence on the ballot argument regarding paying for health insurance from earnings. Remember, we can't do that directly – that's what got us in trouble in the first place. Best left unsaid." Memorandum from Lawrence B. Grissom, Retirement Administrator, to Cathy Lexin, Labor Relations Manager (Aug. 8, 1996).

<sup>245</sup> See, e.g., Memorandum from Terri Aja Webster, Assistant Auditor and Comptroller, to San Diego City Employee Retirement Board (June 30, 2001); Memorandum from Terri Webster, Assistant Auditor & Comptroller, to Larry Grissom, Retirement Administrator (Mar. 31, 2000); Memorandum from Terri Aja Webster, Assistant Auditor and Comptroller, to San Diego City Employee Retirement Board (Nov. 20, 1998).

payment was actually being spent on retiree healthcare benefits.<sup>246</sup> City officials understood the true nature of this “wash transaction”: the scheme enabled the City to perpetuate the illusion that Surplus Earnings were not being diverted to non-pension-related purposes while at the same time reducing its pension contribution.<sup>247</sup>

Today, retiree healthcare benefits are no longer paid out of or indirectly funded by SDCERS Surplus Earnings. In February 2005, the City Council adopted a recommendation of the Pension Reform Committee when it passed an ordinance that used the City’s General Fund to pay for retiree healthcare costs.<sup>248</sup> However, for over two decades, the City effectively paid for its retiree health insurance premium costs out of SDCERS Surplus Earnings through a progression of shrewd adaptations of its retiree healthcare funding scheme.

## **H. The *Corbett* Litigation**

On July 16, 1998, SDCERS was sued by a class of retired employees who alleged, based on court decisions in other California jurisdictions,<sup>249</sup> that the City’s method of calculating retiree pension benefits improperly excluded the value of certain benefits such as vacation and sick leave in computing the employees’ base salaries.<sup>250</sup> Although the City was not named as a defendant, it was identified in the First Amended Complaint as a real party in interest.<sup>251</sup> The *Corbett* plaintiffs sought an across-the-board upward adjustment in the pensions to which they and future retirees were purportedly entitled.<sup>252</sup>

---

<sup>246</sup> See, e.g., Memorandum from Terri Aja Webster, Assistant Auditor and Comptroller, to San Diego City Employee Retirement Board (June 30, 2001); Memorandum from Terri Webster, Assistant Auditor & Comptroller, to Larry Grissom, Retirement Administrator (Mar. 31, 2000); Memorandum from Terri Aja Webster, Assistant Auditor and Comptroller, to San Diego City Employee Retirement Board (Nov. 20, 1998).

<sup>247</sup> In unidentified handwritten notes dated March 10, 2000, an official in the Auditor and Comptroller’s Office (likely Terri Webster) explained the rationale for the retiree healthcare benefit payment schedule: “Per Larry [Grissom] the CERS Fund is a 401(a) fund and \$ can’t be spent on anything but 401(a) purposes – which doesn’t include health. Therefore have to do this ‘wash transaction’, where a portion of City’s contribution is designated for health & it goes in 401(h). Then when it comes to distributing excess earnings a transfer is made to the employer reserve to make it whole.” Memorandum from Terri Aja Webster, Assistant Auditor and Comptroller, to San Diego City Employee Retirement Board (June 25, 1999), with Handwritten Notes dated Mar. 10, 2000.

<sup>248</sup> Minutes, San Diego City Council Meeting at 27-28 (Feb. 1, 2005); Executive Summary, City of San Diego Pension Reform Committee Final Report at 41-42 (Sept. 15, 2004).

<sup>249</sup> See, e.g., *Ventura Co. Deputy Sheriffs’ Assoc. v. Bd. of Ret. of Ventura Co. Employees’ Ret. Assoc.*, 16 Cal. 4<sup>th</sup> 483, 940 P.2d 891 (Cal. 1997).

<sup>250</sup> Complaint, *Corbett v. City Employees’ Ret. Sys.*, No. 722449, at ¶ 13 (Cal. Super. Ct. July 16, 1998).

<sup>251</sup> First Amended Complaint, *Corbett v. City Employees’ Ret. Sys.*, No. 722449, at 1 (Cal. Super. Ct. Oct. 28, 1998).

<sup>252</sup> First Amended Complaint, *Corbett v. City Employees’ Ret. Sys.*, No. 722449, at 7 (Cal. Super. Ct. Oct. 28, 1998).



Because rulings in related cases had been both clear and unfavorable to the City's legal position, the City decided to settle the *Corbett* litigation rather than contest it.<sup>253</sup> Pursuant to the *Corbett* settlement, the SDCERS funded ratio was not permitted to fall below 90%.<sup>254</sup> The City agreed to give the *Corbett* plaintiffs certain benefit increases, but it provided that these new benefits, to the extent that they were owed to already retired employees, would be paid out of Surplus Earnings only insofar as Surplus Earnings were available after other "Waterfall" payments.<sup>255</sup> If Surplus Earnings were not available, this portion of the *Corbett* obligations would accrue until sufficient Surplus Earnings became available.<sup>256</sup>

In March 2000, SDCERS actuary Rick Roeder reported to SDCERS Administrator Lawrence Grissom that the *Corbett* settlement created increased retirement liabilities of \$102 million with respect to active employees and an additional \$84 million with respect to retirees.<sup>257</sup> SDCERS included the first liability in calculating its funded ratio, which, because of the *Corbett* settlement, declined from 94.4% to 90.3% – barely above the 90% limit set by the City Council – as of June 30, 1999.<sup>258</sup> SDCERS treated the liability to retirees as "contingent" and did not include it in calculating the funded ratio.<sup>259</sup> If it had, the SDCERS funded ratio would have declined a further 3.1% to 87.2% – below the level acceptable to the Council and perilously close to the 82.3% trigger under MP-1.<sup>260</sup> Terri Webster recognized that the City's method of satisfying the Council's directive not to allow the funded ratio to fall below 90% was "misleading"

---

<sup>253</sup> Memorandum from Bruce A. Herring, Deputy City Manager, to the Honorable Mayor and Councilmembers (Apr. 13, 2000); City Council Closed Session Presentation (Mar. 14, 2000); City Council Closed Session Presentation (Mar. 6, 2000).

<sup>254</sup> City Council Closed Session Presentation (Mar. 14, 2000).

<sup>255</sup> E-mail from Terri Webster to Ed Ryan (Apr. 4, 2000); San Diego City Council Closed Session Presentation (Mar. 14, 2000); Notice of Proposed Settlement of Class Action, *Corbett v. City Employees' Ret. Sys.*, No. 722449 (Cal. Super. Ct. Apr. 4, 2000).

<sup>256</sup> Notice of Proposed Settlement of Class Action, *Corbett v. City Employees' Ret. Sys.*, No. 722449 (Cal. Super. Ct. Apr. 4, 2000); Interview by Vinson & Elkins with Bruce Herring (June 10, 2004). The *Corbett* settlement also included a one-time, retroactive lump-sum payment to retirees which was not contingent.

<sup>257</sup> Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000).

<sup>258</sup> Memorandum from Bruce A. Herring, Deputy City Manager, to Honorable Mayor and Councilmembers (Apr. 13, 2000); Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000).

<sup>259</sup> Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000); *see, e.g.* Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 15 (Feb. 12, 2002).

<sup>260</sup> Memorandum from Bruce A. Herring, Deputy City Manager, to Honorable Mayor and Councilmembers (Apr. 13, 2000); Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000); City Manager, Retirement System Proposal at 7 (Consolidated from Proposal Dated June 17, 1996, as Modified by June 21, 1996); *see, e.g.* Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 15 (Feb. 12, 2002).

and recommended advising the Council of how its mandate had been met in order “to avoid surprises later.”<sup>261</sup> The Council was “advised” by having a copy of Mr. Roeder’s letter distributed to it.<sup>262</sup>

After the City structured the settlement to define a portion of the *Corbett* obligations as “contingent” rather than absolute – that is, “contingent” on the availability of sufficient Surplus Earnings – the SDCERS Board and staff next argued that “contingent” obligations did not need to be included in its actuarial valuations.<sup>263</sup> Although the SDCERS actuary, Rick Roeder, protested the exclusion of the *Corbett* “contingent” liability from the actuarial valuations (particularly the calculation of the funded ratio), and advice was given that this treatment raised fiduciary concerns, the SDCERS Board overruled its own professionals and agreed to the City’s request to treat it as contingent.<sup>264</sup> To his credit, SDCERS actuary Rick Roeder insisted on including a comment in the SDCERS actuarial valuations explaining what the SDCERS funded ratio would be if *Corbett* benefits were included.<sup>265</sup>

This actuarial treatment was improper. The *Corbett* obligations were in no meaningful sense contingent. The City’s own outside counsel recognized this fact.<sup>266</sup> Sooner or later, the “contingent” obligations absolutely had to be paid out of Surplus Earnings, and the amount of the obligation was readily ascertainable each year. It is unlikely that the *Corbett* plaintiffs would have agreed to the settlement if it had not given them an absolute right to increased benefits. Pretending that these new benefits did not impact the

---

<sup>261</sup> Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000); E-mail from Terri Webster to Bruce Herring (Apr. 6, 2000); E-mail from Bruce Herring to Terri Webster (Apr. 10, 2000); Interview by Vinson & Elkins with Bruce Herring (June 10, 2004). This method was “misleading” because it included the Unified Port District (“UPD”) in order to maintain the 90% funded ratio. By including UPD, the City attained a 90.3% funded ratio, but if UPD had not been included in the funded ratio, it would have been below 90%.

<sup>262</sup> Memorandum from Bruce A. Herring, Deputy City Manager, to Honorable Mayor and Council Members (Apr. 13, 2000); Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000).

<sup>263</sup> Minutes, SDCERS Board Meeting at 31-32 (Jan. 17, 2003); Minutes, SDCERS Board Meeting at 15-20 (Dec. 20, 2002); E-mail from Robert Blum to Larry Grissom cc to Conny Hiatt (July 3, 2002); Minutes, SDCERS Board Meeting at 18-19 (Feb. 15, 2002); Minutes, SDCERS Board Meeting at 8-10 (Mar. 16, 2001); Minutes, SDCERS Board Meeting at 13 (Feb. 16, 2001).

<sup>264</sup> Letter from Constance M. Hiatt to Loraine E. Chapin, Esq., General Counsel (Apr. 16, 2002); Memorandum from City Auditor and Comptroller to Honorable Mayor and City Council (Apr. 11, 2000); Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000); Interview by Vinson & Elkins with Lawrence Grissom (Feb. 14, 2005). It should be noted that Robert Blum, another attorney from Hanson Bridgett, provided SDCERS with an opinion several months later reversing course and stating that the *Corbett* liabilities could be treated as contingent as per the settlement agreement. E-mail from Robert Blum to Lawrence Grissom cc to Connie M. Hiatt (July 3, 2002).

<sup>265</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 2002, at 15 (Jan. 9, 2003); Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000); Interview by Vinson & Elkins with Lawrence Grissom (Feb. 14, 2005).

<sup>266</sup> Letter from Constance M. Hiatt to Loraine E. Chapin, Esq., General Counsel at 5 (Apr. 16, 2002).

funded ratio was improper, and both the City and the SDCERS Board – which had the explicit advice of its own professionals – knew it.<sup>267</sup>

## **I. The Mayor's Blue Ribbon Committee Report**

Richard Murphy was elected Mayor in November 2000. In his first “State of the City” address two months later, Mayor Murphy called for a “Blue Ribbon” committee, consisting of private citizens, to assist the Mayor and City Council in evaluating the fiscal health of the City.<sup>268</sup> In April 2001, Mayor Murphy appointed the Committee’s nine members, to be assisted by then-City Auditor and Comptroller Ed Ryan, and his deputy, Terri Webster.<sup>269</sup> One of the items the Committee decided to address, perhaps at Mr. Ryan’s and Ms. Webster’s suggestion,<sup>270</sup> was the City’s pension system.<sup>271</sup> Subsequent to the Committee’s formation, Richard Vortmann, a San Diego businessman, agreed to spearhead the Committee’s review of the City’s pension system.<sup>272</sup>

The Blue Ribbon Committee on City Finances (“BRC” or “the Committee”) was originally scheduled to complete its work and report its findings by September 2001, and drafts of much of its report appear to have been completed by that time.<sup>273</sup> Meetings of the BRC were suspended, however, until

---

<sup>267</sup> Letter from Constance M. Hiatt to Loraine E. Chapin, Esq., General Counsel at 5 (Apr. 16, 2002); Interview by Vinson & Elkins with Lawrence Grissom (Feb. 14, 2005).

The City’s independent auditors, at the request of the Audit Committee, confirmed the conclusion with the staff of the Governmental Accounting Standards Board that the amount due under the *Corbett* settlement should have been included in the AAL by SDCERS. The higher AAL would have increased the ARC and the Annual Pension Cost (“APC”) for the City each year starting in 2002. The increase in the ARC for the year, which was not funded by the City, would also increase the NPO recorded in the City’s financial statements.

<sup>268</sup> Ray Huard, *New Mayor Establishes 10 Goals to Improve City*, San Diego Union-Tribune, Jan. 9, 2001, at A1.

<sup>269</sup> Minutes, Blue Ribbon Committee on City Finances Meeting (June 15, 2001). The nine members of the Committee were: (i) Joe Craver, President and CEO of Galaxie Management, Inc., who served as the Chair, (ii) April Boling, an independent CPA, who served as the Vice-Chair, (iii) Mary Ball, President, San Diego Taxpayers Association, (iv) William McCurine, Jr., a partner at the law firm of Solomon, Ward, Seidenwurm & Smith, LLP, (v) Andrew Poat, former Chief Deputy Director, CALTRANS, (vi) April Riel, a CPA and Certified Fraud Examiner, (vii) Victor Vilaplana, an attorney at the law firm of Seltzer Caplan McMahon Vitek, (viii) Richard Vortmann, President, National Steel and Shipbuilding Company, and (ix) Linc Ward, Chair, Zero-Based Management Review of the Select Committee. Blue Ribbon Committee Report on City of San Diego Finances at 2 (Feb. 2002).

<sup>270</sup> Interview by the Audit Committee with Richard Vortmann (May 1, 2006).

<sup>271</sup> Minutes, Blue Ribbon Committee on City Finances Meeting (June 15, 2001) (noting that information regarding “Unfunded Pension Liability” was distributed but not discussed by the Committee).

<sup>272</sup> Minutes, Blue Ribbon Committee on City Finances Meeting (July 13, 2001). Mr. Vortmann was later appointed to the SDCERS Board by the Mayor in September 2001. Press Release, Mayor Dick Murphy, Mayor Murphy Appoints Two to Retirement Board (Sept. 21, 2001).

<sup>273</sup> Blue Ribbon Committee Work Plan (undated); E-mail from Leilani Hughes to Joseph W. Craver cc to Terri Webster (Sept. 5, 2001); Minutes, Blue Ribbon Committee on City Finances Meeting (Aug. 31, 2001).

December 2001, and the Committee did not present its report to the City Council Committee on Rules, Finance and Intergovernmental Relations (“the City Council Rules Committee”) until February 27, 2002.<sup>274</sup> Although memories differ about the reasons for the delay and about any influence exerted on the tone and content of the final report, it is clear both that the Committee’s work was postponed, and that the language of its report was toned down, in order to avoid interfering with the City’s Ballpark Bond offering.<sup>275</sup> The bond offering closed on February 14, 2002, and the City was plainly concerned that a public report highlighting serious problems with the funding of SDCERS would make the bond offering more difficult or impossible.<sup>276</sup>

For example, in her handwritten notes of the August 31, 2001 BRC meeting, Terri Webster, the City’s Assistant Auditor and Comptroller, noted: “Brought up by committee: timing and content of report; don’t want to mess w/ballpark bonds.”<sup>277</sup> In December 2001, Ms. Webster complained to Joseph Craver, Chairman of the BRC, about the “doom and gloom” tone of the conclusions adopted by Mr. Vortmann, who was responsible for the Committee’s work on pension funding, and asked Mr. Craver to “turn him [Vortmann].”<sup>278</sup> After a draft of the Blue Ribbon Committee Report on City of San Diego Finances (“BRC Report”) report was completed in mid-January, Assistant City Manager Lamont Ewell congratulated Webster for “mastermind[ing] . . . an incredible attitudinal turn around of the committee.”<sup>279</sup> And after the Committee completed drafting its report, Mr. Vortmann wrote his fellow BRC members expressing his dissatisfaction with the tone of the report:

After much discussion of whether the ‘sky was really falling’ and did we really want to say all that, we, as a group, with my concurrence, evolved to the final version of our conclusion i.e. ‘the city is in good fiscal shape, but . . . The committee’s unstated concern over the ball park financing and any

---

<sup>274</sup> Transcript, San Diego City Council Committee on Rules, Finance and Intergovernmental Relations, Blue Ribbon Committee Discussion (Feb. 27, 2002); Minutes, Blue Ribbon Committee on City Finances Meeting (Dec. 21, 2001); Minutes, Blue Ribbon Committee on City Finances Meeting (Aug. 31, 2001).

<sup>275</sup> The Ballpark Bond offering was a bond issuance to fund the construction of a new baseball stadium, now known as Petco Park, for the San Diego Padres. Work on the new ballpark had begun years earlier, but had stalled due to lack of funding.

<sup>276</sup> In handwritten notes from September 10, 2001, apparently discussing BRC Chairperson Joe Craver’s agenda for the preparation and content of the BRC Report, Terri Webster wrote: “Per Joe – knows about ballpark 10-21-01. Report will *not* come out before that. Wants [E]d’s read on it *first draft before* [sic] goes to rest of committee; does *not* want to start with all is doom & gloom, which it isn’t.” Handwritten Notes of Terri Webster (Sept. 10, 2001) (emphasis in original).

<sup>277</sup> Handwritten Notes of Terri Webster (Aug. 31, 2001); Interview by the Audit Committee with Dennis Gibson (Apr. 25, 2006) (noting that he perceived a general concern about the negative impact the BRC Report might have on the City’s current bond ratings, and that such negative ratings could eventually “implicate” the Ballpark Bonds when issued).

<sup>278</sup> E-mail from Terri Webster to Joseph Craver (Dec. 31, 2001).

<sup>279</sup> E-mail from Terri Webster to Lamont Ewell (Jan. 15, 2002).

impact to the city's credit rating in general are now behind us. However certain recent developments since our report deliberation seems [sic] to accentuate the 'buts' we made in our report.<sup>280</sup>

The apparent stake of City employees like Mr. Ewell and Ms. Webster in the BRC's findings – not to mention the dramatic influence that Ms. Webster had in crafting the final report – undermined the goal of objective independence for the BRC's findings. Though many members of the BRC supported Ms. Webster and Mr. Ryan in the process for negotiating the tone of the report, the active role played by these City staff members undeniably influenced the BRC members' understanding of the larger implications of their report, in particular the City's need to maintain strong financial ratings with the Ballpark Bonds offering on the horizon. Given the scope of Ms. Webster's and Mr. Ryan's involvement with the BRC, it is not surprising that, in the end, the report's tone was tempered to meet the needs they perceived the City to have for the issuance of the Ballpark Bonds, rather than serving as a non-governmental analysis of the City's fiscal health.

In November 2001, in advance of the City Council's approval of the Ballpark Bonds, Assistant City Attorney Leslie Girard coordinated a closed session presentation, at which the Mayor and City Council reviewed a legal memorandum prepared by outside counsel, Gerald Boltz and Matthew Anhut of Bryan Cave LLP ("Bryan Cave")<sup>281</sup> The memorandum (the "Bryan Cave Memo") warned that Council members "cannot simply 'rubber stamp' the [disclosure] document."<sup>282</sup> Rather, they must:

act with reasonable care. This includes, at a minimum: (1) reviewing the entire [Preliminary Official Statement ("POS")]; (2) asking for clarification as to material parts of the POS that a member may need additional guidance; (3) seeking information and asking questions of the officials, employees, and professionals who supplied information to be included in the POS; and (4) asking follow up questions to determine the reasonableness of any assumptions or estimates that were used in the POS.<sup>283</sup>

---

<sup>280</sup> Letter from Richard H. Vortmann, President, NASSCO, to Joseph Craver, Mary Ball, April Boling, Dennis Gibson, Bill McCurine, Andrew Poat, Aprilrose Riel, Victor Vilaplana, Ed Ryan, Terri Webster, and Linc Ward (Apr. 29, 2002).

<sup>281</sup> Memorandum from Leslie J. Girard, Assistant City Attorney, to Honorable Mayor and Members of the City Council (Nov. 6, 2001), with attached Letter from Gerald E. Boltz and Matthew D. Anhut, Bryan Cave LLP, to Leslie J. Girard, Esq. (Oct. 29, 2001).

<sup>282</sup> Letter from Gerald E. Boltz and Matthew D. Anhut, Bryan Cave LLP, to Leslie J. Girard, Esq. (Oct. 29, 2001).

<sup>283</sup> Letter from Gerald E. Boltz and Matthew D. Anhut, Bryan Cave LLP, to Leslie J. Girard, Esq. (Oct. 29, 2001).

This memorandum was followed by an oral presentation by Mr. Boltz, who repeated his description of Councilmembers' duties under the securities laws.<sup>284</sup>

On February 27, 2002, days after the issuance of the Ballpark Bonds, the BRC presented its report to the City Council Rules Committee and the Mayor.<sup>285</sup> As to the City's pension system, the Committee came to four conclusions. First, the Committee concluded that the City was not paying enough out of its current year budget to fund the pension and retirement health benefits that were being earned by its current work force.<sup>286</sup> The Committee noted a shortfall in the City's funding of these benefits of \$6-8 million for fiscal year 2001 and a cumulative shortfall of \$31 million for fiscal years 1997 through 2000.<sup>287</sup> Second, the Committee concluded that the City's actuarially determined pension obligations, as a percentage of City payroll, were increasing dramatically, from 8.8% in 1992 to 14.1% in 2001, and could be expected to increase even more in the future.<sup>288</sup> The Committee noted that this increase resulted from increased pension benefits, including benefits added as a result of the *Corbett* litigation, exacerbated by the continued underfunding of the SDCERS plan.<sup>289</sup> Third, the Committee concluded the City had failed to quantify or budget for retiree health benefits, which the City had been paying for on a "pay as you go" basis out of SDCERS Surplus Earnings but which were likely to exceed this funding source in the near future.<sup>290</sup> Fourth,

---

<sup>284</sup> Interview by the Audit Committee with Matthew Anhut (May 25, 2006); Interview by the Audit Committee with Scott Peters (May 1, 2006). Thereafter, the City Council approved several issuances that were false and misleading, as discussed *infra*.

<sup>285</sup> Transcript, San Diego City Council Committee on Rules, Finance and Intergovernmental Relations, Blue Ribbon Committee Discussion (Feb. 27, 2002).

<sup>286</sup> Blue Ribbon Committee Report on City of San Diego Finances at 23 (Feb. 2002).

<sup>287</sup> Blue Ribbon Committee Report on City of San Diego Finances at 23 (Feb. 2002). These numbers were provided by Deputy City Auditor Terri Webster and Ed Ryan, who assisted Mr. Vortmann with his review. According to the draft issue memoranda prepared by Vinson & Elkins in July 2005, the numbers were wrong: the FY 2001 shortfall was actually \$12,163,106 and the cumulative shortfall for years 1997 through 2001 was \$69,292,644. Paul S. Maco and Richard C. Sauer, Potential Violations of the Federal Securities Laws by the City of San Diego and Assorted Individuals at 49 (Draft July 15, 2005).

<sup>288</sup> Blue Ribbon Committee Report on City of San Diego Finances at 23 (Feb. 2002).

<sup>289</sup> Blue Ribbon Committee Report on City of San Diego Finances at 20-23 (Feb. 2002).

<sup>290</sup> Blue Ribbon Committee Report on City of San Diego Finances at 21-23 (Feb. 2002). In response to Mr. Vortmann's inquiries, SDCERS Administrator Lawrence Grissom estimated that the City's liability for retiree healthcare benefits was in the range of \$100-\$200 million, but warned Mr. Vortmann not to rely on that number. Mr. Vortmann, in an interview with Vinson & Elkins, guessed that the \$100 million figure in the BRC Report came from Larry Grissom, but was not certain. Interview by Vinson & Elkins with Richard Vortmann (June 8, 2004). The last professional evaluation of the City's liability for these benefits had been provided by Buck Consultants in 1989. Buck Consultants, City of San Diego Design and Funding of Postretirement Medical Benefits at 29-30 (Draft Apr. 1989). At that time, Buck Consultants had estimated the present value of the City's unfunded liability at \$145 million using the EAN funding method and \$103 million using the PUC funding method. The Report noted merely that the City's unfunded retirement benefit liability "could exceed \$100 million." While not technically false, this was an understatement. In 2003, in a report to the City Council, SDCERS estimated the present value of the

the Committee concluded that the existence of a growing unfunded liability at SDCERS was troubling, especially in light of the nine-year bull market for equity investments, which should have erased the plan's unfunded liability.<sup>291</sup>

Overall, the Committee criticized the City's policy of increasing employee benefits retroactively without providing a funding source for them, emphasizing that this policy risked the City's financial health by imposing potentially enormous costs on future generations of taxpayers.<sup>292</sup> To address this failing, the Committee recommended, first, that the City begin funding, on a current basis, its future pension and retirement health obligations as they are earned and, second, that the City obtain a comprehensive analysis of projected pension expenses and revenue sources, including an assessment of the present value of retiree health benefits.<sup>293</sup>

A number of critical facts that would have highlighted the extent of the underfunding, and the potential fiscal threat posed to the City by SDCERS's declining funded ratio, were left unmentioned in the Committee's report. Mr. Vortmann had only a cursory understanding of the effect of MP-1 at the time the BRC Report was issued, and he was just learning about pension issues at this time.<sup>294</sup> As a result, the BRC Report failed to include a substantive discussion of MP-1 – describing the City's contribution scheme only as an “unconventional actuarial driven plan” – and, in particular, failed to mention the budgetary ramifications of hitting the system's “trigger” point.<sup>295</sup> This omission was particularly significant given that Ms. Webster, at the very least, knew as early as October 2001 that SDCERS's investment returns had declined dramatically from the prior year and the system would have trouble making its Waterfall payments out of SDCERS Surplus Earnings.<sup>296</sup> By December 2001, Ms. Webster was aware the investment returns were 87% lower than the previous year as of October 31, 2001.<sup>297</sup> And by April 2002, Ms. Webster knew the SDCERS funded ratio was projected to fall below the 82.3% threshold, so that a massive new infusion of City funds to

---

retiree health liability at \$1.1 billion – but even this number was little more than a guess. Memorandum from SDCERS to City Council Committee on Rules, Finance and Intergovernmental Relations at 8 (Feb. 12, 2003).

<sup>291</sup> Blue Ribbon Committee Report on City of San Diego Finances at 23 (Feb. 2002).

<sup>292</sup> Blue Ribbon Committee Report on City of San Diego Finances at 20-23 (Feb. 2002).

<sup>293</sup> Blue Ribbon Committee Report on City of San Diego Finances at 23 (Feb. 2002).

<sup>294</sup> Interview by the Audit Committee with Richard Vortmann (May 1, 2006).

<sup>295</sup> Blue Ribbon Committee Report on City of San Diego Finances at 21 (Feb. 2002).

<sup>296</sup> E-mail from Cathy Lexin to Terri Webster (Oct. 11, 2001).

<sup>297</sup> E-mail from Terri Webster to Lawrence Grissom cc to Cathy Lexin (Dec. 3, 2001).

restore the funded ratio was a near certainty.<sup>298</sup> It is astonishing that Ms. Webster shepherded the BRC process to completion without once alerting BRC members to the alarming prospect of a breach of the 82.3% floor. The inclusion of the potential consequences of MP-1 would have dramatically amplified the urgency of the BRC Report's findings.

The BRC Report contained additional omissions that, while perhaps subject to a benign explanation, nevertheless softened the report's discussion of SDCERS's funding problems and presented them in the best possible light. For example, the report stated that SDCERS's funded ratio was "currently" at 97% and further indicated that the plan's UAAL for the 2001 fiscal year was "not available."<sup>299</sup> The "current" figure in fact reflected the funded ratio as of June 30, 2000, and did not account for the economic downturn that occurred in the year and a half since that time.<sup>300</sup> Moreover, on February 12, 2002 – two weeks before the BRC Report was presented to the City Council Rules Committee – the SDCERS actuary issued his annual valuation report to the SDCERS Board showing the plan's funded ratio as of June 30, 2001, was 89% and its UAAL was \$283.89 million – reflecting a significant funding deterioration in FY 2001.<sup>301</sup>

One issue the BRC Report did raise was a concern over rising costs of healthcare premiums.<sup>302</sup> Like a report issued over a decade earlier by SDCERS's former actuarial firm, Buck Consultants, the BRC Report recommended both that healthcare liability be calculated on a regular basis and that this liability be actuarially funded.<sup>303</sup> Although the City Auditor and Comptroller's Office staff expressed

---

<sup>298</sup> E-mail from Terri Webster to Lawrence Grissom (Apr. 15, 2002).

<sup>299</sup> Blue Ribbon Committee Report on City of San Diego Finances at 22 (Feb. 2002).

<sup>300</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2000, at 17 (Mar. 8, 2001).

<sup>301</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 10, 14 (Feb. 12, 2002). Mayor Murphy received an advance presentation of the BRC Report on February 14, 2002. Interview by the Audit Committee with Mayor Murphy (May 2, 2006); Interview by the Audit Committee with Richard Vortmann (May 1, 2006).

<sup>302</sup> Blue Ribbon Committee Report on City of San Diego Finances at 21-23 (Feb. 2002).

<sup>303</sup> Blue Ribbon Committee Report on City of San Diego Finances at 23 (Feb. 2002); Buck Consultants, City of San Diego Design and Funding Postretirement Medical Benefits, accompanied by cover letter to Jack McGrory, Assistant City Manager, City of San Diego, at 1 (Draft Apr. 24, 1989).

Through the years, there have been a number of attempts to estimate the healthcare liability. These estimates range widely from \$100 million to more than \$1 billion. Blue Ribbon Committee Report on City of San Diego Finances at 22 (Feb. 2002) (\$100 million); SDCERS Response to the Blue Ribbon Committee Report on City Finances, Regarding Pension and Health Insurance Funding at 8-9 (Feb. 12, 2003) (\$1.1 billion); Memorandum from Rick Roeder to Pension Reform Commission (June 14, 2004) (between \$604 million and \$938 million); Towers Perrin, City of San Diego Postretirement Welfare Benefit Plan, Actuarial Valuation Report with Estimated Results at 2 (Draft June 2004) (\$753 million). The current estimate of the City's healthcare liability is \$1 billion. Press Release, Office of Mayor Jerry Sanders, *Sanders Announces \$1 Billion Retiree Medical Liability; Liability Grows to \$1.8 Billion in 9 Years* (Mar. 14, 2006).



some support for the reforms suggested by the BRC during the initial drafting of their report and concurred that rising healthcare costs were a concern, it did not agree that retiree healthcare was an expense that should be actuarially funded.<sup>304</sup>

A year after receiving the Blue Ribbon Committee Report, SDCERS addressed the Report's findings in a presentation to the City Council Rules Committee.<sup>305</sup> During this presentation by Fred Pierce and Lawrence Grissom, SDCERS estimated the present value of the retirement healthcare liability at more than \$1 billion (\$400 million to current retirees and \$750 million to active employees).<sup>306</sup>

In June 2004, SDCERS actuary Rick Roeder performed a further analysis of healthcare liability for the Pension Reform Committee.<sup>307</sup> Mr. Roeder estimated the retiree healthcare liability to be between \$604 and \$938 million.<sup>308</sup> That same month, Towers Perrin, upon request of the City, also analyzed the healthcare liability, calculating it to be more than \$750 million as of June 30, 2003.<sup>309</sup> While there may have been disagreement about the size of the actual liability, it is clear that every attempt to analyze the liability showed it to be extremely large and/or recommended that it be actuarially funded.

Following the February 27, 2002 presentation of the BRC Report, Mayor Murphy directed City Manager Michael Uberuaga to present a preliminary response at the next City Council Rules Committee meeting as to how each issue raised by the BRC should be approached.<sup>310</sup> At the March 20, 2002 City Council Rules Committee meeting, the questions concerning the City's funding of the pension system were

---

<sup>304</sup> E-mail from Terri Webster to Leilani Hughes (Sept. 4, 2001). As Terri Webster pointed out, "Generally Accepted Principles for Government and Pensions does not require booking health future costs nor is it required that health be actuarially funded."

<sup>305</sup> PowerPoint Presentation, San Diego City Employees' Retirement System: Report on the Mayor's Blue Ribbon Committee on City Finances (Feb. 6, 2003).

<sup>306</sup> PowerPoint Presentation, San Diego City Employees' Retirement System: Report on the Mayor's Blue Ribbon Committee on City Finances at 6, 9 (Feb. 6, 2003). During their interviews with Vinson & Elkins, Lawrence Grissom called a \$1.1 billion estimate a "wild guess" and Rick Roeder referred to it as "SWAG" – "some wild-assed guess." Interview by Vinson & Elkins with Rick Roeder (June 2, 2004); Interview by Vinson & Elkins with Larry Grissom (Apr. 22, 2004).

<sup>307</sup> Letter from Rick Roeder to Pension Reform Commission (June 14, 2004).

<sup>308</sup> Letter from Rick Roeder to Pension Reform Commission (June 14, 2004). Although Mr. Roeder does not state what actuarial method he is using to calculate the healthcare liability, he presumably was using PUC, the method he employed for SDCERS's financial statements.

<sup>309</sup> Towers Perrin, City of San Diego Postretirement Welfare Benefit Plan, Actuarial Valuation Report with Estimated Results at 2 (Draft June 2004). Towers Perrin used PUC as its actuarial method to calculate the healthcare liability.

<sup>310</sup> Transcript, San Diego City Council Committee on Rules, Finance and Intergovernmental Relations, Blue Ribbon Committee Discussion at 40-41 (Feb. 27, 2002).

referred to SDCERS for further review, setting an initial deadline of June 30, 2002 for its response.<sup>311</sup> In May 2002, the SDCERS Board requested and received an extension for its report to September 30, 2002.<sup>312</sup> In fact, the SDCERS Board did not make its presentation in response to the BRC Report until the February 12, 2003 City Council Rules Committee meeting.<sup>313</sup>

Thus, the BRC report on pension financing was first delayed for months so as not to interfere with the Ballpark financing, then put on the shelf for a full year to await a formal response from SDCERS. During the intervening year, it became apparent that the 82.3% funded floor would be breached, MP-2 was enacted as an emergency solution, and the *Gleason* lawsuit, which eventually led to the repudiation of MP-2, was filed.<sup>314</sup> The SDCERS response to the BRC Report took note of these alarming developments and added a new one: it estimated that retiree health benefits, paid out of so-called Surplus Earnings, were now an additional UAAL liability of \$1.1 billion.<sup>315</sup> But, by 2003, it was too late to anticipate and correct the pension funding problems through timely action.

## **J. Events Leading Up To Manager's Proposal 2**

Manager's Proposal 2 was the City's and SDCERS's response to a pension funding crisis that, by 2002, required immediate action. The specifics of the MP-2 proposal, and its ramifications for the City, will be discussed in detail below. Here, we discuss the primary factors that led to MP-2: (i) the growth in unfunded pension obligations resulting from increased benefits *and* the City's continued underfunding of its pension system; (ii) SDCERS's declining investment performance in 2001 and 2002; and (iii) the resulting deterioration of SDCERS's funded ratio in 2001 and 2002, which threatened to cause the MP-1 funded ratio floor of 82.3% to be breached, creating a huge new payment obligation for the City.<sup>316</sup>

---

<sup>311</sup> Memorandum from Mayor Dick Murphy to San Diego City Council (Apr. 4, 2002). In attendance at this meeting were Mayor Murphy, Council members Atkins, Wear, and Stevens, City Manager Uberuaga, and Financial Management Director Lisa Irvine, among other staff. Transcript, San Diego City Council Committee on Rules, Finance and Intergovernmental Relations, Blue Ribbon Committee Discussion (Mar. 20, 2002).

<sup>312</sup> Memorandum from Frederick W. Pierce IV, Retirement Board President, to Michael T. Uberuaga, City Manager (May 13, 2002).

<sup>313</sup> Action Items, San Diego City Council Committee on Rules, Finance and Intergovernmental Relations of the City Council of the City of San Diego (Feb. 12, 2003).

<sup>314</sup> San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002); Complaint, *Gleason v. San Diego City Employees' Ret. Sys.*, No. GIC 803779 (Cal. Super. Ct. Jan. 16, 2003).

<sup>315</sup> Memorandum from SDCERS to City Council Committee on Rules, Finance and Intergovernmental Relations (Feb. 12, 2003).

<sup>316</sup> E-mail from Terri Webster to Cathy Lexin (Oct. 11, 2001); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001 (Feb. 12, 2002); E-mail from Terri Webster to Ed Ryan (Feb. 12, 2002).

## 1. The Growth in SDCERS's Unfunded Benefits

Since the early 1980s, the City and SDCERS had grown accustomed to tapping Surplus Earnings to pay a host of miscellaneous expenses. MP-1 uncoupled the City's payments to SDCERS from any growth in these expenses, including new benefits granted in the 1996 meet and confer process and the financial effects of new actuarial assumptions that went into effect beginning in fiscal year 1996. Following the adoption of MP-1, SDCERS's obligations grew in a number of unanticipated ways, and no new funding was made available to cover these new expenses. The result was an increase in the City's growing pension funding gap.<sup>317</sup>

The largest single new obligation was the increased pension payments due as a result of the *Corbett* settlement in 2000. Although this settlement had two components – an initial lump-sum payment to retired members (non-contingent) and increased annual payments from SDCERS (characterized as contingent) – the City did not correspondingly increase its contributions to the pension system.<sup>318</sup> SDCERS actuary Roeder estimated the non-contingent portion of this liability in March 2000 as \$102 million for current employees, and estimated the contingent portion of this liability with respect to retired and vested deferred members (who had left City employment) as an additional \$84 million.<sup>319</sup> These figures increased the system's unfunded liability because they were to be paid from Surplus Earnings and, thus, decreased the system's assets.

---

<sup>317</sup> From fiscal year 1996 through fiscal year 1999, the UAAL increased by approximately \$19 million. Compare Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1996, at 12 (Jan. 9, 1997) (showing a UAAL of \$129,321,983) with Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1999, at 11 (Feb. 14, 2000) (showing a UAAL of \$148,394,209). The impact MP-1 had in increasing SDCERS's UAAL during this time period is particularly glaring considering the fact that pension plans across the country experienced solid growth in assets during the bull market of the late 1990's. Bruce Kelly, *Banner Year: U.S. Pension Funds Finish the Decade in Tiptop Shape*, Pensions & Investments, Jan. 10, 2000, at 1 ("Because of rising equity markets and rising interest rates, pension fund assets outgrew liabilities at a record pace in 1999"); *Diversify or Die*, Funds International, Apr. 1999, at 10 ("The US pension fund market overcame the effects of extremely volatile domestic and international markets during the third quarter of 1998 to record another successful financial year. Overall, the value of US pension fund assets increased by more than 20 percent, or \$740 billion"); Stephen Gandel, *NY Pension Fund Retreats on U.S. Stock Investment*, Crain's New York Business, Feb. 28, 2000, at 4 ("The [New York public pension] fund, which increased its stock market allocation the last time it reweighted in 1996, has benefited from the recent bull market").

<sup>318</sup> Notice of Proposed Settlement of Class Action, *Corbett v. City Employees' Ret. Sys.*, No. 722449, at 5 (Cal. Super. Ct. Apr. 4, 2000); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 23 (Jan. 9, 2003); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 23 (Feb. 12, 2002); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2000, at 23 (Mar. 8, 2001); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 1999, at 23 (Feb. 14, 2000).

<sup>319</sup> Letter from Rick A. Roeder to Larry Grissom (Mar. 30, 2000).

SDCERS had also paid the healthcare costs of retired employees out of Surplus Earnings since the early 1980s.<sup>320</sup> This was so, even though the expected total liability for these costs was not required to be included when SDCERS calculated its Actuarial Accrued Liability. As healthcare premiums rose, this unfunded benefit became an increasing drain on SDCERS earnings, along with *Corbett* benefits and the 13<sup>th</sup> Check.<sup>321</sup>

In 1998, the City granted its employees additional pension benefits as part of its “meet and confer” process for that year, which were also to be funded from SDCERS earnings. Surplus Earnings were tapped to establish a reserve to ensure that cost-of-living adjustments would be available to protect the real value of retirees’ benefits, and to establish an additional reserve to pick up a portion of the employees’ contributions to SDCERS going forward.<sup>322</sup> This diversion of SDCERS assets was approved by actuary Rick Roeder and by SDCERS’s outside counsel Robert Klausner.<sup>323</sup> Because MP-1 fixed the City’s contributions to SDCERS, these new, unfunded benefit enhancements contributed to SDCERS’s growing UAAL.<sup>324</sup>

## 2. SDCERS’s Declining Investment Performance in 2001 and 2002

While SDCERS’s obligations grew and City contributions to meet those obligations remained capped by MP-1, the stock market began a dramatic downturn after the first quarter of 2000.<sup>325</sup> One consequence of the downturn was a decline in the funded status of retirement funds.<sup>326</sup> Credit rating services, such as Moody’s Investors Service; professional retirement plan advisors, such as Wilshire Associates; and general business periodicals, such as *BusinessWeek*, reported that the significant investment losses at pension plans, both public and private, in the wake of this market decline left many plans with unfunded liabilities.<sup>327</sup> SDCERS was no different. SDCERS saw its total return on investments decline from 14.93%

---

<sup>320</sup> San Diego, Cal., Ordinance O-15758 (June 1, 1982).

<sup>321</sup> In February 2003, SDCERS estimated that the current costs of benefits funded out of Surplus Earnings –retiree healthcare costs, *Corbett* benefits, 13<sup>th</sup> Check, and the like – was at least \$20 million. Memorandum from SDCERS to City Council Committee on Rules, Finance and Intergovernmental Relations at 10 (Feb. 12, 2003).

<sup>322</sup> Memorandum from Michael T. Uberuaga, City Manager, to Keith Enerson, President, Board of Administration, City Employees’ Retirement System (May 14, 1998).

<sup>323</sup> Letter from Robert D. Klausner to Lawrence B. Grissom, Administrator (June 10, 1998); Letter from Rick A. Roeder to Larry Grissom (May 29, 1998).

<sup>324</sup> Letter from Rick A. Roeder to Larry Grissom (May 29, 1998).

<sup>325</sup> Warren Vieth and Stephanie Simon, *Recession Seeps Into the Corners*, L.A. Times, Dec. 4, 2001, at A1.

<sup>326</sup> Moody’s Investors Service, *Special Comment: Moody’s Perspective on Increased Pension Costs for California Local Governments* (June 2003).

<sup>327</sup> *The Benefits Trap*, *BusinessWeek* (July 19, 2004) (“Three years of stock market declines plus record-low interest rates have left pension funds woefully underfunded.”); Wilshire Associates, *2004 Wilshire Report on City & County*

for fiscal year ending June 30, 2000, to negative 0.45% for fiscal year 2001 and negative 2.48% in fiscal year 2002.<sup>328</sup> During this period, SDCERS's returns fell far short of its actuarially assumed rate of 8%.<sup>329</sup>

SDCERS's declining investment performance did not go unnoticed by City officials. In fact, it should have been (and probably was) clear to Ms. Webster and other SDCERS and City officials that the MP-1 trigger likely would be reached by the actuary's next valuation, if not before.<sup>330</sup> In October 2001, Deputy Auditor and SDCERS Board member Terri Webster wrote to fellow Board member and Deputy City Manager Cathy Lexin, in an e-mail titled "EEEEK," that:

YTD CERS earnings as of August 31, 2001 in the CERS Trust fund is about \$15m compared with \$53M same time 2000 . . . a 71% drop! BEFORE 9-11-01! It will be tight to even meet the base undistributed earnings distributions for FY 02 (i.e., 13th check, corbett, etc.).

I hope meet and confer negotiations result in returning as much of the \$100m as possible to employer reserves because the Trust Fund really need[s] to build its equity and halt cost increases to ride through the next few years and keep a fiscally sound funding ratio.<sup>331</sup>

By early December, the situation had grown increasingly grim. On December 3, 2001, Ms. Webster sent an e-mail titled "earnings EEEK," this time to SDCERS Administrator Lawrence Grissom, which she signed "Sleepless in San Diego":

---

*Retirement Systems: Funding Levels and Asset Allocation* (Oct. 1, 2004); Wilshire Associates, *2003 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation* (Mar. 12, 2003) ("The ratio of pension assets-to-liabilities, or *funding ratio*, for all state pension plans combined declined from 106% in 2001 to 91% in 2002."); Moody's Investors Service, *Special Comment: Moody's Perspective on Increased Pension Costs for California Local Governments* (June 2003).

<sup>328</sup> Memorandum from SDCERS to City Council Committee on Rules, Finance and Intergovernmental Relations at 4 (Feb. 5, 2003).

<sup>329</sup> Memorandum from SDCERS to City Council Committee on Rules, Finance and Intergovernmental Relations at 4 (Feb. 12, 2003). Allegations have been raised that Callan Associates, Inc. ("Callan"), SDCERS's investment consultant, had a conflict of interest in that it had economic relationships with certain of the investment managers it recommended to the SDCERS Board. Interview by the Audit Committee with Diann Shipione (June 21, 2006). This potential conflict might have pressured Callan to continue to recommend under-performing investment managers, impairing the return SDCERS was able to obtain on its investments. To the extent Callan's actions constituted improper or illegal behavior in this regard, such actions might provide the basis for a claim by the City against Callan. Indeed, the City has filed just such a lawsuit against Callan alleging that Callan recommended poor-performing investment managers under a so-called "pay to play scheme" rather than recommending them based on the managers' abilities to suit the needs of SDCERS. The lawsuit further alleges that this was a conflict of interest that was not disclosed to the City. First Amended Complaint, *City of San Diego v. Callan Associates, Inc.*, No. GIC 852419, at 20 (Cal. Super. Ct. Aug. 8, 2005).

<sup>330</sup> E-mail from Terri Webster to Ed Ryan (Feb. 12, 2002); E-mail from Terri Webster to Mary Vattimo (Feb. 12, 2002); E-mail from Cathy Lexin to Terri Webster (Oct. 11, 2001).

<sup>331</sup> E-mail from Cathy Lexin to Terri Webster (Oct. 11, 2001).

Oct statements showed \$15.4 m loss on sale of stocks and a total monthly loss of \$7m bringing YTD earnings at Oct 31, 2001 to only \$14.1 million compared to \$107 m last year same time. A 87% decrease ! EEEK!<sup>332</sup>

The losses continued in December, and Ms. Webster informed her boss, City Auditor Ed Ryan, of her concerns about funding the basic retirement benefits.<sup>333</sup> Of particular concern to Ms. Webster was the impact of SDCERS's declining performance on the availability of Surplus Earnings needed to fund the City's "Waterfall" benefits. As she noted in her e-mail to Mr. Ryan, which was copied to fellow SDCERS Board member Cathy Lexin, in January 2002:

CERS fund earnings as of 11-30-01 was \$17.4 million compared to \$112.6 at 11-30-00 (85% decrease) . . . In order to fund the basic items listed in the Muni Code out of earnings using FY 01 numbers . . . \$118m is needed . . . these are SERIOUS consequences and needs attention.<sup>334</sup>

The news had only gotten worse when Mr. Grissom informed Ms. Webster on February 12, 2002 that the finalized actuary report for the fiscal year ending June 30, 2001, prepared by Mr. Roeder, showed a \$200 million loss, which dropped the SDCERS funded ratio to 90% as of June 30, 2001, a 7% drop from the previous report.<sup>335</sup> In an e-mail that same day to Mr. Ryan discussing the plummeting funded ratio, Ms. Webster reminded him of the elephant in the room: "The trigger point is 82%."<sup>336</sup> That evening, Ms. Webster asked Ms. Vattimo to have the SDCERS staff or Board "direct" Mr. Roeder to advise them as to his estimated funded ratio for FY 2002, alerting her that "[t]he 82% trigger point is looking WAY too close."<sup>337</sup> Ms. Webster expressed her exasperation to Mr. Grissom in a February 27, 2002 e-mail, imploring him to come up with projections and solutions.<sup>338</sup> The next day, Ms. Webster informed Mr. Ryan, Ms. Vattimo, Ms. Lexin, and Mr. Herring that Mr. Grissom had spoken with Fred Pierce, and that they needed a projected funded ratio by March.<sup>339</sup>

By February 2002, it was clear that the City, members of the SDCERS Board, the SDCERS actuary and the SDCERS Administrator all knew SDCERS's investment earnings were plummeting and the

---

<sup>332</sup> E-mail from Terri Webster to Lawrence Grissom (Dec. 3, 2001).

<sup>333</sup> E-mail from Terri Webster to Ed Ryan (Jan. 3, 2002).

<sup>334</sup> E-mail from Terri Webster to Ed Ryan (Jan. 3, 2002).

<sup>335</sup> E-mail from Terri Webster to Ed Ryan (Feb. 12, 2002).

<sup>336</sup> E-mail from Terri Webster to Ed Ryan (Feb. 12, 2002).

<sup>337</sup> E-mail from Terri Webster to Mary Vattimo (Feb. 12, 2002).

<sup>338</sup> E-mail from Terri Webster to Larry Grissom (Feb. 27, 2002).

<sup>339</sup> E-mail from Terri Webster to Ed Ryan, Mary Vattimo, and Cathy Lexin cc to Bruce Herring (Feb. 28, 2002).

funded ratio was in danger of falling below the trigger of 82.3%. Several individual SDCERS Board members, including Richard Vortmann, Ray Garnica, and Fred Pierce, understood this as well in February and March.<sup>340</sup> Any elected City official who did not know of this danger learned of it on March 18, 2002, in a memorandum discussing the 2002 “meet and confer,” when the Mayor and City Council were officially informed by the Labor Relations Manager Daniel Kelley that the funded ratio had significantly declined, approaching 85.6% or 83.1% (depending on how it was calculated), and that if it fell below the MP-1 trigger, the City would be required to pay the “full rate,” which was estimated to be “a potential \$40 [million] annual impact.”<sup>341</sup>

On April 15, 2002, SDCERS Administrator Lawrence Grissom sent an e-mail to Ms. Webster advising her that recent negative developments “without any other actuarial losses or additions to liabilities for new benefits, etc. put us at about 80%.”<sup>342</sup> In other words, by April 2002, Mr. Grissom and Ms. Webster were aware the financial performance of the fund was such that the actual funded ratio was likely to fall below the 82.3% trigger as of June 30, 2002.<sup>343</sup> Furthermore, Mr. Grissom’s assessment was without regard to the additional 2% reduction that would result if *Corbett* benefits were accounted for properly. Without an immediate and dramatic turnaround in investment performance – which did not, in fact, materialize – the actuarial report for fiscal year 2002 would inevitably show that the MP-1 trigger had been hit. Mr. Grissom asked Ms. Webster to “[p]lease treat this [information] as confidential for the moment.”<sup>344</sup>

### 3. Approaching the MP-1 Trigger

Beginning in 2000, the SDCERS funded ratio – the ratio of the Actuarial Value of Assets available to pay benefits under the plan to the total Actuarial Accrued Liability of the plan – declined steeply. From 97.3% as of June 30, 2000, the funded ratio declined to 89.9% one year later.<sup>345</sup> In the same one-year period, SDCERS’s UAAL – the shortfall between the actuarial value of the plan’s assets and its actuarial

---

<sup>340</sup> E-mail from Terri Webster to Ray Garnica (March 18, 2002); Letter from Richard H. Vortmann, NASSCO President, to Frederick W. Pierce IV, Chairman – San Diego City Employees’ Retirement System (Feb. 18, 2002).

<sup>341</sup> Memorandum from Daniel E. Kelley, Labor Relations Manager, to Honorable Mayor and City Council (March 15, 2002); *see also* Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>342</sup> E-mail from Terri Webster to Larry Grissom (Apr. 15, 2002).

<sup>343</sup> E-mail from Terri Webster to Mary Vattimo (Feb. 12, 2002); E-mail from Mary Vattimo to Terri Webster and Cathy Lexin (Feb. 27, 2002).

<sup>344</sup> E-mail from Terri Webster to Larry Grissom (Apr. 15, 2002).

<sup>345</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 2001, at 13 (Feb. 12, 2002).

accrued liability – increased from \$68.96 million to \$283.89 million, a nearly 400% increase.<sup>346</sup> By the spring of 2002 – when the City once again concluded negotiations with its four main labor unions as part of the 2002 “meet and confer” process – SDCERS’s funded ratio was already projected to fall below the MP-1 trigger.<sup>347</sup>

With an official breach of the MP-1 trigger looming, City and SDCERS officials began to discuss the financial consequences to the City of the breach.<sup>348</sup> According to the proposal which set forth the terms of MP-1:

In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation which will include the impact of the benefit improvements included in this Proposal [92.3 percent], the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. *The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation.*<sup>349</sup>

Although the proposal seems, by its terms, to require the City to fully restore SDCERS’s funding to a ratio of 82.3% no later than July 1 of the year immediately following a trigger “hit,” Mr. Grissom stated in 2002 that he believed the City was required only to begin paying the full PUC rate at that time, not to make a one-time payment to bring the funded ratio up to the 82.3% floor.<sup>350</sup> Mr. Grissom’s new interpretation was adopted by certain members of the SDCERS Board and by the City Manager’s Office.<sup>351</sup>

The financial impact of this interpretation was significant. For example, the City Manager’s Office estimated that, under its interpretation, the City owed SDCERS approximately an additional \$20-\$26

---

<sup>346</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 2001, at 9 (Feb. 12, 2002).

<sup>347</sup> E-mail from Terri Webster to Larry Grissom (Apr. 15, 2002).

<sup>348</sup> E-mail from Terri Webster to Ray Garnica (Mar. 18, 2002); E-mail from Larry Grissom to Richard Vortmann cc to Fred Pierce (Mar. 13, 2002).

<sup>349</sup> Memorandum from Cathy Lexin, Labor Relations Manager, to Larry Grissom, Retirement Administrator (July 23, 1996) *attaching* City Manager, Retirement System Proposal (Consolidated from Proposal Dated June 7, 1996, as Modified by June 21, 1996 Proposal) (emphasis added).

<sup>350</sup> E-mail from Larry Grissom to Richard Vortmann cc to Fred Pierce (Mar. 13, 2002).

<sup>351</sup> E-mail from Terri Webster to Cathy Lexin and Bruce Herring (Mar. 13, 2002). In an April 15, 2002, closed session meeting concerning meet and confer issues, the City management team apparently presented a PowerPoint slide show to the City Council advancing the interpretation that a breach of the trigger would only require a return to the full actuarial rate. One of the slides in this presentation states: “If CERS funding ratio drops below 82.3% (currently 89.9%) City must pay full actuarial rate, \$25m more annually.” PowerPoint Presentation, San Diego City Council Meet & Confer 2002 Closed Session (Apr. 15, 2002).



million in the first year after the trigger was hit.<sup>352</sup> In contrast, if the funded trigger were read to require the City to fully restore SDCERS's funded ratio to 82.3%, the City would have owed, in FY 2003, an estimated lump-sum payment of at least \$75 million.<sup>353</sup> Even this estimate, based on the assumption that the funded ratio as of June 30, 2002 would be 80%, was far too low. The actual ratio turned out to be 77.3%, not counting *Corbett* "contingent" liabilities, which would have reduced the ratio 2% more.<sup>354</sup> Fully restoring the 82.3% funded ratio in FY 2003 probably would have cost the City approximately \$160 million.<sup>355</sup>

## **K. Manager's Proposal 2**

During the spring of 2002, the City and its municipal unions engaged in "meet and confer" negotiations, the point of which was to reach a multi-year agreement regarding salary and benefits for City employees.<sup>356</sup> Early on in the meet and confer process, it was understood by City officials that there were serious financial consequences to the City if the MP-1 trigger was breached.<sup>357</sup> As City Auditor Ed Ryan noted in an e-mail dated February 28, 2002, addressed to Cathy Lexin (a SDCERS Board member who also served as the City's chief negotiator in the meet and confer process) and Deputy City Manager Bruce Herring:

Cathy[,] Bruce [sic] You might want to use Ron Saathoff to get their [the Board's] attention. I don't believe you can conclude meet and confer without knowing what retirement is going to do. That means they have to tell the City likely by the March meeting. I believe the Manager has to tell Council the budget status before meet and confer concludes and he'd have to know the retirement solution to do that.<sup>358</sup>

---

<sup>352</sup> E-mail from Terri Webster to Ray Garnica (Mar. 18, 2002); E-mail from Terri Webster to Cathy Lexin and Bruce Herring (Mar. 13, 2002).

<sup>353</sup> This was the interpretation adopted at least by SDCERS actuary Rick Roeder and fiduciary counsel Robert Blum. Minutes, SDCERS Board Meeting at 20 (June 21, 2002); Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (Draft June 12, 2002).

<sup>354</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 13-15 (Jan. 9, 2003).

<sup>355</sup> Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 13 (Jan 9, 2003).

<sup>356</sup> Minutes, SDCERS Board Meeting at 2 (July 11, 2002); Minutes, SDCERS Special Meeting at 36 (May 29, 2002); Memorandum from Daniel E. Kelley, Labor Relations Manager, to Honorable Mayor and City Council (Mar. 15, 2002).

<sup>357</sup> Minutes, SDCERS Board Meeting at 25 (July 11, 2002); Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Honorable Mayor and City Council (June 14, 2002); E-mail from Terri Webster to Cathy Lexin and Bruce Herring (Mar. 13, 2002); E-mail from Terri Webster to Mary Vattimo (Feb. 12, 2002); E-mail from Terri Webster to Ed Ryan (Feb. 12, 2002).

<sup>358</sup> E-mail from Mary Vattimo to Ed Ryan, Terri Webster, and Cathy Lexin cc to Bruce Herring (Feb. 28, 2002).

By March, it was clear to the Council it was likely that the City could owe up to an extra \$40 million to the pension the next year.<sup>359</sup>

It was in the context of these discussions that the Mayor and City Council, in closed sessions in April and May 2002, agreed to a proposal which would condition certain retirement benefits on the SDCERS Board's agreement to eliminate or reduce the MP-1 trigger.<sup>360</sup> In exchange, the City agreed to increase the basic multiplier (the number multiplied by a retiree's years of creditable service and then by his highest one-year salary to arrive at his annual retirement benefit) for retirement benefits for general employees to 2.5% from 2.25%.<sup>361</sup>

Among the new retirement benefits agreed upon during the 2002 meet and confer and considered by the City Council in April and May 2002 were "Presidential Leave and Retirement Benefits" ("Presidential Leave").<sup>362</sup> Presidential Leave was a benefit to the presidents of three municipal unions, the Police Officers' Association ("POA"), the International Association of Firefighters, AFL-CIO ("Local 145"), and the Municipal Employees' Association ("MEA").<sup>363</sup> One of the union presidents, Ronald Saathoff of Local 145, was a member of the SDCERS Board.

Until 2002, the POA and MEA presidents – who were employed by their unions and not the City during their tenures as union presidents – had made contributions to SDCERS through their

---

<sup>359</sup> Memorandum from Daniel E. Kelley, Labor Relations Manager, to the Honorable Mayor and City Council (Mar. 15, 2002); Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>360</sup> E-mail from Terri Webster to Ed Ryan and Dan Kelley cc to Bob Lawrence, Bob Wilson, and Elmer Heap (May 21, 2002); Memorandum from Daniel E. Kelley, Labor Relations Manager, to Management Team (May 17, 2002); Memorandum from Michael T. Uberuaga, City Manager, to Lawrence B. Grissom, Retirement Administrator (May 15, 2002); Proposal from City of San Diego to San Diego City Firefighters Local 145 (May 10, 2002); San Diego City Council, Closed Session Report, with attached PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (May 6, 2002); PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (Apr. 29, 2002); Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Hon. Mayor and City Council (Apr. 26, 2002); E-mail from Terri Webster to Elmer Heap and Michael Rivo cc to Cathy Lexin (Apr. 17, 2002); Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Deputy City Attorney, to Honorable Mayor and City Council (Apr. 12, 2002), with attached PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (Apr. 15, 2002).

<sup>361</sup> City of San Diego (City) Proposal to the San Diego Municipal Employees' Association (MEA) regarding Implementation of Enhanced Retirement Benefits, Amendment to the Memorandum of Understanding between the City and MEA (May 29, 2002); San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002).

<sup>362</sup> PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (Apr. 29, 2002); Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Deputy City Attorney, to Honorable Mayor and City Council (Apr. 12, 2002), with attached PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (Apr. 15, 2002).

<sup>363</sup> Although a fourth union, AFSCME Local 127, was authorized to participate in the Presidential Leave Program, it never opted to do so during the period of our investigation. Letter from Ice Miller to the Internal Revenue Service (July 12, 2005).

respective unions based on their union salaries.<sup>364</sup> Thus, they expected their retirement benefits to be calculated based on their high-one year salaries.<sup>365</sup> However, the legality of this arrangement previously had been questioned, as it was not clear that union employees could contribute to SDCERS based on their union salaries.<sup>366</sup> Mr. Saathoff, by contrast, was employed *jointly* by the City and Local 145, with his (and the City's) contribution to SDCERS based on his salary paid by the City.<sup>367</sup> His retirement benefit, in turn, was expected to be based on his high one-year *City* salary – approximately 70% of his total compensation.<sup>368</sup>

The resolution implementing the Presidential Leave benefit provided that the retirement benefits of the incumbent presidents of the POA, MEA and Local 145, and the two former POA presidents who had not yet retired from City service, would be based on their high one-year *combined* union and City salaries.<sup>369</sup> However, because the MEA and POA presidents were paid union, but not City, salaries, this ordinance essentially ratified the existing arrangement for the POA and MEA presidents.<sup>370</sup> Thus, the resolution, insofar as it implemented Presidential Leave, affected only Mr. Saathoff, the only union president who was paid by both the City and by his union.<sup>371</sup> Presidential Leave had no economic impact on the other union presidents beyond codifying the benefits they would receive on account of contributions they had

---

<sup>364</sup> E-mail from Theresa McAteer to Cathy Lexin, Dan Kelley, Ed Ryan, Eugene Ruzzini, and Terri Webster (Jan. 19, 2001); Memorandum from Cathy Lexin, Human Resources Director & (*unidentified*), Deputy City Attorney, to Honorable Mayor and City Council (Draft Nov. 13, 2001); PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (Apr. 29, 2002).

<sup>365</sup> Draft Memorandum from Cathy Lexin, Human Resources Director & (*unidentified*), Deputy City Attorney, to Honorable Mayor and City Council (Draft Nov. 13, 2001).

<sup>366</sup> E-mail from Theresa McAteer to Cathy Lexin, Dan Kelley, Ed Ryan, Eugene Ruzzini, and Terri Webster (Jan. 19, 2001), forwarding an e-mail from Terri Webster to unknown recipients (Jan. 19, 2001); Memorandum from Cathy Lexin, Human Resources Director & (*unidentified*), Deputy City Attorney, to Honorable Mayor and City Council (Draft Nov. 13, 2001).

<sup>367</sup> E-mail from Judy Zellers to Lawrence Grissom (Sept. 20, 2001); Memorandum on Local 145 High One Year Calculation (Nov. 5, 2001); Memorandum from Cathy Lexin, Human Resources Director & (*unidentified*), Deputy City Attorney, to Honorable Mayor and City Council (Draft Nov. 13, 2001); PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (Apr. 29, 2002).

<sup>368</sup> Memorandum on Local 145 High One Year Calculation (Nov. 5, 2001).

<sup>369</sup> San Diego City Council Resolution R-297212 (Oct. 21, 2002). The Presidential Leave benefit passed by unanimous vote, with Council members Scott Peters, Toni Atkins, Byron Wear, Brian Maienschein, Donna Frye, James Madaffer, George Stevens, Ralph Inzunza, and Mayor Murphy voting in favor of the resolution. Minutes, San Diego City Council Meeting at 30-31 (Oct. 21, 2002).

<sup>370</sup> E-mail from Dan Kelley to Cathy Lexin (June 4, 2002); San Diego City Council Resolution R-297212 (Oct. 21, 2002).

<sup>371</sup> E-mail from Judy Zellers to Lawrence Grissom (Sept. 20, 2001); Memorandum on Local 145 High One Year Calculation (Nov. 5, 2001); E-mail from Dan Kelley to Cathy Lexin (June 4, 2002); San Diego City Council Resolution R-297212 (Oct. 21, 2002).

already been making to SDCERS. Mr. Saathoff, on the other hand, received an immediate, substantial increase in pension benefits at absolutely no cost to him.<sup>372</sup>

It was no accident Mr. Saathoff was able to reap this special benefit in 2002. City officials viewed Mr. Saathoff as critical to obtaining the SDCERS Board's support for MP-2.<sup>373</sup> Ms. Webster wrote to labor negotiator Dan Kelley, expressly seeking his assurance that Mr. Saathoff would support the trigger waiver proposal.<sup>374</sup>

The local 145 [Firefighters Union] write up you sent out did not state that their increased offset was contingent on the Board laxing the trigger. . . . I thought ALL retirement improvements (including the presidential leave (?), were contingent on the trigger . . . *especially need Ron behind releasing the trigger since he runs the show at CERS.*<sup>375</sup>

Michael McGhee, another labor negotiator, provided that assurance to Ms. Webster later that day: "I assure you that Ron is well aware of the contingent nature of the benefits."<sup>376</sup>

Shortly after this e-mail exchange, on June 10, 2002, City Manager Michael Uberuaga, on behalf of the Mayor and City Council, formally approached the SDCERS Board and requested that it

---

<sup>372</sup> Memorandum on Local 145 High One Year Calculation (Nov. 5, 2001); E-mail from Judy Zellers to Lawrence Grissom (Sept. 20, 2001). The U.S. Attorney estimates the increase in Mr. Saathoff's benefit to be over \$25,000 per year. Indictment, *U.S. v. Saathoff*, No. 06 Cr. 0043, at ¶ 13 (S.D. Cal. 2006). While this number seems approximately correct, we have not been able to determine how it was calculated.

City Attorney Michael J. Aguirre has alleged that the Presidential Leave benefit dramatically increased Mr. Saathoff's retirement benefits. Second Amended Complaint, *People v. Grissom*, No. 850246, at ¶ 99 (Cal. Super. Ct. July 6, 2005).

<sup>373</sup> E-mail from Terri Webster to Dan Kelley (May 21, 2002).

In a criminal action brought by the State of California against Ron Saathoff and other former SDCERS Board members, Mr. Saathoff argued that the Presidential Leave benefit and the Resolution codifying the benefit was not contingent on the SDCERS Board's approval of MP-2. Memorandum of Points and Authorities in Support of Motion to Set Aside Information Pursuant to Penal Code Section 995, *People v. Lexin*, No. SCD 190930, at 60, 64 (Cal. Super. Ct. May 17, 2005).

<sup>374</sup> Ms. Webster was in a unique position herself vis-à-vis the other members of SDCERS with respect to the 2002 meet and confer proposal. While the agreement to enhance retirement benefits was, as a general matter, subject to a provision capping total benefits at 90% of a member's highest one year salary, an exception was provided for members who were under the age of 24 when they began their employment with the City. Evidence available to the Audit Committee shows that this was done in an attempt to avoid inequities such as the diminution in value of any purchases of PSCs. Ms. Webster was one of 300 employees citywide who met this criterion – and the only one on the SDCERS Board. See E-mail from Holly Reed-Falk (Sept. 23, 2002); E-mail from Terri Webster to Dan Kelley cc to Paul Barnett, Holly Reed-Falk, Michael Rivo, and Sharon Marshall (May 17, 2002); Interview by Vinson & Elkins with Holly Reed-Falk (Mar. 8, 2005); Interview by Vinson & Elkins with Daniel Kelley (Apr. 12, 2005).

<sup>375</sup> E-mail from Terri Webster to Dan Kelley (May 21, 2002) (emphasis added).

<sup>376</sup> E-mail from Mike McGhee to Ed Ryan, Terri Webster, and Dan Kelley cc to Bob Lawrence, Bob Wilson and Elmer Heap (May 21, 2002).

approve the following amendments to MP-1: (i) a reduced funded ratio trigger of 75% instead of 82.3%; and (ii) an agreement that, in the event the new trigger was breached, the City would be permitted to ramp up its contributions over five years in order to achieve the full actuarial rate, rather than making an onerous payment in 2003.<sup>377</sup>

Significantly, the City Manager's proposal for amending MP-1 addressed only what the City stood to gain from the proposal. This is because, in the end, the City's proposal provided no benefit at all to SDCERS. In effect, the City was proposing not only that it be permitted to avoid paying what it owed to SDCERS under MP-1, but also that it be granted additional contribution relief while at the same time burdening SDCERS with additional unfunded benefits.<sup>378</sup>

The following week, SDCERS received the analysis it had sought from its fiduciary counsel, Robert Blum and Constance Hiatt of the law firm Hanson Bridgett Marcus Vlahos & Rudy, LLP ("Hanson Bridgett"), and its actuary, Rick Roeder.<sup>379</sup> Mr. Blum and Ms. Hiatt, in a draft opinion letter dated June 12, 2002, advised the SDCERS Board there was a "material risk" that a court would regard approval of MP-2, as proposed, to be a breach of its fiduciary duty.<sup>380</sup> In particular, Mr. Blum and Ms. Hiatt emphasized that the proposal did not contain any "mitigating actions" – such as increasing the City's scheduled contributions to

---

<sup>377</sup> Memorandum from Michael T. Uberuaga, City Manager, to San Diego City Employees' Retirement System Board of Administration via Lawrence B. Grissom, Retirement Administrator (June 10, 2002).

<sup>378</sup> Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom (Draft June 12, 2002). A clear example of this type of unfunded liability was a benefit negotiated by Ron Saathoff for the Firefighters' Union (Local 145) in connection with MP-2. The benefit enabled employees to, among other things, convert years of accrued Annual Leave to PSCs in a *cashless* transaction. San Diego, Cal., Ordinance O-19126 (Dec. 3, 2002); Minutes, San Diego City Council Meeting at 9-10 (Nov. 18, 2002). Prior to the adoption of the implementing ordinance, employees could opt to receive cash in exchange for days of annual leave they had accrued. With the adoption of this new benefit – which was introduced at the November 18, 2002, meeting at which the City Council approved the majority of other MP-2 benefit enhancements – employees could instead receive credits for their accrued annual leave, rather than cash. Employees could then convert their credits into years of service (or PSCs) rather than buying the PSCs directly from SDCERS. The City therefore saved money by not paying cash to employees who elected to convert their annual leave, while simultaneously paying nothing to SDCERS to cover the costs of the (already underpriced) PSCs. The net effect of this benefit was to move a liability from the City and roll it into the UAAL. Notably, this benefit was made available exclusively to members of Mr. Saathoff's union and no others. E-mail from Terri Webster to Bruce Herring and Cathy Lexin cc to Ed Ryan (May 9, 2002); San Diego, Cal., Ordinance O-19126 (Dec. 3, 2002); Minutes, San Diego City Council Meeting at 9-10 (Nov. 18, 2002).

<sup>379</sup> Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq., SDCERS cc to Michael A. Leone, Esq. (Mar. 5, 2003); Memorandum from Lawrence B. Grissom, Retirement Administrator, to Retirement Board (June 13, 2002); Presentation, Actuarial Information re: Manager's Proposal (dated June 12, 2002); Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom (Draft June 12, 2002).

<sup>380</sup> Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom (Draft June 12, 2002). There is evidence that Mr. Blum's June 2002 advice was strongly influenced by SDCERS Administrator Lawrence Grissom. According to a statement Mr. Blum made to SDCERS attorney Sheila Leone nine months later in the context of defending the *Gleason* litigation, Mr. Grissom had told Mr. Blum to write an opinion that would "kill the Manager's Proposal." Several months later, Mr. Grissom reversed course on MP-2, and put pressure on Mr. Blum to revise his earlier opinion in order to "make it happen." E-mail from Sheila Leone to Lori Chapin cc to Roxanne Story Parks (Mar. 24, 2003).

SDCERS or guaranteeing that the 75% would not similarly be negotiated away later on – that would serve the interests of SDCERS members.<sup>381</sup> Mr. Blum and Ms. Hiatt understood the MP-1 trigger as requiring the City to make a one-time payment to restore SDCERS to a funded level of 82.3% if the funding floor were breached.<sup>382</sup> Assuming the SDCERS funded level fell to 80% by June 2003, they estimated the City would owe an additional \$75 million to SDCERS.<sup>383</sup> Mr. Blum also expressed concerns related to the financial health of the City and its ability to make future debt payments (*i.e.*, larger pension payments) much like any creditor.<sup>384</sup>

On June 18, 2002, the City Manager responded to these criticisms in a memorandum to the SDCERS Board.<sup>385</sup> Although he left the proposed new 75% trigger unchanged, the City Manager agreed to modify his initial proposal by increasing the City’s agreed upon contribution rate, as part of the five-year ramp-up period, from 0.50% of payroll to 1.00% annually.<sup>386</sup> However, the City Manager did not address Mr. Blum and Ms. Hiatt’s concerns regarding the City’s ability to meet the payment obligations of its proposal, noting only that this was a “broad question” and a “plan” was needed.<sup>387</sup>

At a SDCERS Board meeting on June 21, 2002, the SDCERS actuary made a presentation to the Board that was critical of the new Manager’s Proposal.<sup>388</sup> Noting “[t]he role of a fiduciary must be independent of the setting of existing or potential benefits” for members, Mr. Roeder stated that he was “concerned with the new proposal because of the coupling of benefit increases to funding, along with the significant change from the 82.3% safeguard to 75%.”<sup>389</sup> Mr. Roeder indicated he was “more comfortable” with the 82.3% floor in light of the continuing deterioration of the funded ratio – a trend that he believed

---

<sup>381</sup> Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (June 12, 2002).

<sup>382</sup> Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (June 12, 2002).

<sup>383</sup> Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (June 12, 2002).

<sup>384</sup> Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (June 12, 2002).

<sup>385</sup> Memorandum from Michael T. Uberuaga, City Manager, signed by Bruce Herring, to SDCERS Board of Administration via Lawrence B. Grissom, Retirement Administrator (June 18, 2002).

<sup>386</sup> Memorandum from Michael T. Uberuaga, City Manager, signed by Bruce Herring, to SDCERS Board of Administration via Lawrence B. Grissom, Retirement Administrator (June 18, 2002).

<sup>387</sup> Memorandum from Michael T. Uberuaga, City Manager, signed by Bruce Herring, to SDCERS Board of Administration via Lawrence B. Grissom, Retirement Administrator (June 18, 2002).

<sup>388</sup> Presentation, Actuarial Information re: Manager’s Proposal (dated June 12, 2002).

<sup>389</sup> Minutes, SDCERS Board Meeting at 17-19 (June 21, 2002); Presentation, Actuarial Information re: Manager’s Proposal (dated June 12, 2002).

would continue through 2003.<sup>390</sup> Mr. Roeder clearly objected to the Board's involvement in the benefit-granting process.<sup>391</sup> Like Mr. Blum and Ms. Hiatt, Mr. Roeder interpreted the MP-1 trigger as requiring a \$75 million payment by the City in FY 2003 if the funded ratio floor were breached.<sup>392</sup> Although Mr. Roeder's discussion treated this breach merely as a possibility,<sup>393</sup> he must have recognized that the funded ratio was already below 82.3%, and that, with only days remaining in the fiscal year, it was a foregone conclusion that the MP-1 trigger would be hit. In April 2002, Mr. Grissom informed Ms. Webster that the funded ratio was projected to fall under the trigger.<sup>394</sup> This information could only have come from Mr. Roeder.<sup>395</sup>

The City's June 18th proposal was debated at the June 21st SDCERS Board meeting,<sup>396</sup> and afterwards the City and SDCERS continued to discuss what would be needed for SDCERS to approve the agreement.<sup>397</sup> Cathy Lexin, the City Manager's representative on the Board, and Deputy City Attorney Elmer Heap were worried that the Board was concerned about approving the proposal as it stood. Ms. Lexin and Mr. Heap wrote, in a memorandum to the Council dated July 8, 2002, that the Board's fiduciary counsel, Mr. Blum and Ms. Hiatt, had written an opinion "clearly erring on the side of caution due to the fact that counsel, from their perspective, did not have time to evaluate the proposal sufficiently to render final advice."<sup>398</sup> This statement cast Mr. Blum and Ms. Hiatt's advice in a misleading light by suggesting that their opposition to MP-2 was strictly a result of timing, not substance. The memorandum also stated that the

---

<sup>390</sup> Letter from Rick A. Roeder to Larry Grissom, Retirement Administrator (Nov. 5, 2002); Minutes, SDCERS Board Meeting at 10 (July 11, 2002); Minutes, SDCERS Board Meeting at 17-19, 21-22 (June 21, 2002).

<sup>391</sup> Minutes, SDCERS Board Meeting at 19 (June 21, 2002).

<sup>392</sup> Minutes, SDCERS Board Meeting at 21 (June 21, 2002); Letter from Constance M. Hiatt and Robert Blum to Lawrence Grissom, Retirement Administrator (June 12, 2002).

<sup>393</sup> Minutes, SDCERS Board Meeting at 21 (June 21, 2002).

<sup>394</sup> E-mail from Terri Webster to Lawrence Grissom (Apr. 15, 2002).

<sup>395</sup> *See, e.g.*, E-mail from Lawrence Grissom to Terri Webster (Mar. 6, 2002).

<sup>396</sup> Minutes, SDCERS Board Meeting at 1, 32 (June 21, 2002). The Board unanimously voted to continue discussions regarding the proposal rather than taking a vote on the proposal as it stood; Frederick Pierce, John Casey, David Crow, Ray Garnica, Cathy Lexin, Tom Rhodes, Ron Saathoff, Diann Shipione, John Torres, Terri Webster, Richard Vortmann, and Sharon Wilkinson were present.

<sup>397</sup> E-mail from Robert Blum to Lawrence Grissom cc to Rick Roeder, Constance Hiatt, Lori Chapin, and Paul Barnett (July 8, 2002); Memorandum from Bruce Herring, Deputy City Manager, to Lawrence B. Grissom, Retirement Administrator (July 3, 2002); Letter from Richard H. Vortmann to Fred Pierce and Lawrence Grissom cc to all San Diego City Employees' Retirement System Board Members (June 24, 2002).

<sup>398</sup> Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Honorable Mayor and City Council (July 8, 2002).

Board's concern was exacerbated by the threat of litigation.<sup>399</sup> Given the importance of modifying MP-1 to avoid immediate payment of the full rate, they requested authority from the Mayor and City Council to support an anticipated modification of the proposal, by a SDCERS Board member, leaving MP-1's 82.3% floor intact but permitting the City a five-year ramp-up to the actuarial PUC rate in the event the floor was breached.<sup>400</sup>

On July 11, 2002, the Board met with its fiduciary counsel and actuary to consider the City's latest version of MP-2.<sup>401</sup> Mr. Roeder informed the Board that the 82.3% trigger would likely be breached by June 2003.<sup>402</sup> There was also discussion regarding Mr. Roeder's analysis, concluding with Mr. Blum saying "the revised [Manager's] proposal is better, but [my] opinion has not changed."<sup>403</sup> Finally, Mr. Saathoff proposed that a modified version of MP-2 be approved leaving the 82.3% trigger intact, but with a five-year ramp-up period in place.<sup>404</sup> At the conclusion of the meeting, Mr. Blum and Mr. Roeder were asked to opine on whether adopting MP-2, as modified by Mr. Saathoff, was a prudent exercise of the Board's responsibility.<sup>405</sup> Neither of them could provide an immediate answer, but Mr. Blum indicated that, with the original trigger intact, the modified version of MP-2 was more defensible than the Manager's original proposal.<sup>406</sup> Notably, during the June 21 and July 11 meetings, Mr. Blum and Ms. Hiatt did not address the apparent conflict of interest created by the Board having to vote on a proposal which made enhanced member benefits conditional on contribution relief.<sup>407</sup> The Board ultimately voted on July 11, 2002, to accept Mr.

---

<sup>399</sup> Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Honorable Mayor and City Council (July 8, 2002).

<sup>400</sup> Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Honorable Mayor and City Council (July 8, 2002).

<sup>401</sup> Minutes, SDCERS Board Meeting at 2-38 (July 11, 2002).

<sup>402</sup> Minutes, SDCERS Board Meeting at 10 (July 11, 2002). In fact, although Mr. Roeder advised the Board that the funded ratio trigger would be breached in 2003, it later became clear, when the 2002 actuarial valuation was released, that SDCERS's funded ratio had breached the trigger even before June 30, 2002. According to the 2002 actuarial report, which was issued in January 2003, the funded ratio as of June 30, 2002 was 77%, without regard to *Corbett* "contingent" liabilities equal to about 2% of total liabilities. Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 13, 15 (Jan. 9, 2003).

<sup>403</sup> Minutes, SDCERS Board Meeting at 4-13, 31 (July 11, 2002).

<sup>404</sup> Minutes, SDCERS Board Meeting at 33 (July 11, 2002).

<sup>405</sup> Minutes, SDCERS Board Meeting at 38 (July 11, 2002).

<sup>406</sup> Minutes, SDCERS Board Meeting at 38 (July 11, 2002).

<sup>407</sup> Minutes, SDCERS Board Meeting (July 11, 2002).



Saathoff's modified version of MP-2, in a vote of 8 to 2, with one member abstaining.<sup>408</sup> This modified version kept the trigger at 82.3%, but allowed the City to avoid a balloon payment if the floor was breached, requiring instead that the City ramp up to full actuarial funding over five years. Mr. Saathoff's motion was contingent upon the receipt of a satisfactory written agreement between the City and the Board, and upon the approval of the Board's fiduciary counsel and actuary.<sup>409</sup>

From the record of the Board meeting at which MP-2 was approved, it is apparent that all present recognized the City's motivation in seeking to waive the 82.3% trigger was its recognition that this trigger would be breached in 2003 or earlier, subjecting the City to substantially increased contributions.<sup>410</sup> The evidence also suggests that the discussion at the July 11 meeting was framed by the SDCERS advisors that presented the amended Manager's Proposal in a more positive light. Despite an earlier proposal by Mr. Blum for Mr. Roeder to show the Board what the contributions would be under the different trigger interpretations and assuming the trigger was hit on June 30, 2002, Mr. Roeder's final analysis did not have this information.<sup>411</sup> In fact, when the topic was raised at the July 11, 2002 Board Meeting, the minutes reflect that Mr. Grissom simply noted to the Board that there were two interpretations; however, he also noted that for the purposes of Mr. Roeder's analysis only the trigger interpretation that required the City to jump to the full PUC rate was used.<sup>412</sup> It is also telling that although Mr. Roeder recommended analyzing a scenario for

---

<sup>408</sup> Minutes, SDCERS Board Meeting at 38 (July 11, 2002). The Board members voting to approve were: John Casey (a City official), Mary Vattimo (a City official), Fred Pierce (President of the Board and a private citizen), Ron Saathoff (a union president), Sharon Wilkinson (a member of SDCERS and a City employee), John Torres (a City employee), Terri Webster (a City official) and Cathy Lexin (a City official). Board members voting against the proposal were: Tom Rhodes (police department representative) and David Crow (retiree representative). Except for Mr. Pierce, each of the Board members who voted for the proposal were either City officials, City employees, or Union presidents. Of the four private citizens on the Board, only Mr. Pierce voted for it. Of the other three, one abstained (Ray Garnica) and two left the meeting prior to the vote (Richard Vortmann and Diann Shipione). Interview by the Audit Committee with Richard Vortmann (May 1, 2006) (Mr. Vortmann stated that he now believes the meeting may have been purposefully dragged out so that he and Ms. Shipione were not present for the vote.)

<sup>409</sup> Minutes, SDCERS Board Meeting at 33-34 (July 11, 2002).

<sup>410</sup> Minutes, SDCERS Board Meeting (July 11, 2002).

City Attorney Michael J. Aguirre has alleged that Lawrence Grissom, Ron Saathoff, Joe Torres, Sharon Wilkinson, Terri Webster, Cathy Lexin, Bruce Herring, and Loraine Chapin knew that the trigger would likely be hit by July 11, 2002. Mr. Saathoff, Mr. Torres, Ms. Wilkinson, Ms. Webster, and Ms. Lexin were members of the SDCERS Board at that time. Second Amended Complaint, *People v. Grissom*, No. 850246 (Cal. Super. Ct. Dec. 12, 2005). Ms. Lexin testified at a deposition taken in connection with a lawsuit challenging the legality of MP-1 and MP-2 that the City had a concern that the trigger might be affected in the spring of 2002. Deposition of Cathy Lexin (Jan. 30, 2004), *Gleason v. San Diego City Employees' Ret. Sys.*, No. GIC 803779 (Cal. Super. Ct. Jan. 16, 2003).

<sup>411</sup> E-mail from Robert Blum to Loraine Chapin, Lawrence Grissom, and Paul Barnett, attaching SDCERS Actuarial Considerations - Revised Managers Proposal First Cut Data Questions (June 24, 2002); Memorandum from Gabriel, Roeder, Smith & Co. on Analysis of Proposed Change to Manager's Proposal (July 11, 2002).

<sup>412</sup> Minutes, SDCERS Board Meeting at 7, 10, 12, 15 (July 11, 2002).

the July 11, 2002 Board meeting assuming 0% investment earnings, Mr. Grissom's official request to Mr. Roeder apparently only included the 4%, 8%, and 12% investment earnings scenarios which the Board ultimately saw.<sup>413</sup> Thus, the Board's advisors failed to provide a complete analysis of relevant funding scenarios to enable Board members to evaluate accurately the implications of their vote on MP-2.

It was not until late July, after Ms. Lexin had already voted to approve the proposal at the July 11, 2002 SDCERS Board meeting, that Mr. Blum advised Mr. Grissom, Mr. Barnett, and Ms. Chapin that Ms. Lexin's on-going role as a negotiator may present a conflict of interest.<sup>414</sup> Mr. Blum's concern was with Ms. Lexin negotiating the agreements that emerged from the Board's adoption of MP-2 while wearing her "City hat," and subsequently intending to vote on the same agreements in her capacity as a Board member.<sup>415</sup> Mr. Blum's revelation, however, came too late, since Ms. Lexin also acted as a negotiator just months earlier in connection with the 2002 meet and confer while acting as a Board member.<sup>416</sup> It appears that he (along with Ms. Hiatt and Ms. Chapin) simply failed to appreciate the conflict earlier on, and once they did, they failed to identify its application to Ms. Lexin's earlier conduct. In any event, Mr. Blum's concern was apparent when he warned Mr. Grissom, Mr. Barnett, and Ms. Chapin on September 22, 2002, "PLEASE DO NOT give [the draft opinion letter] to cathy lexin . . . cathy and crew will use it to negotiate and i dont [sic] want them to have that advantage . . . cathy probably will be all over you on monday to get a copy. DONT [sic] DO IT."<sup>417</sup>

Mr. Roeder provided a written opinion on MP-2 on November 5, 2002.<sup>418</sup> In his opinion, Mr. Roeder repeated his belief that it was likely the 82.3% trigger would be breached by June 30, 2003, and

---

<sup>413</sup> E-mail from Rick Roeder to Bob Blum cc to Constance Hiatt and Lawrence Grissom (July 2, 2002); E-mail from Rick Roeder to Larry Grissom cc to Constance Hiatt, Bob Blum, and Paul Barnett (June 25, 2002).

<sup>414</sup> Minutes, SDCERS Board Meeting at 38 (July 11, 2002); E-mail from Robert Blum to Lawrence Grissom, Paul Barnett, and Loraine Chapin cc to Connie Hiatt (July 30, 2002).

<sup>415</sup> E-mail from Robert Blum to Lawrence Grissom, Paul Barnett, and Loraine Chapin cc to Connie Hiatt (July 30, 2002).

<sup>416</sup> E-mail from Robert Blum to Lawrence Grissom, Paul Barnett, and Loraine Chapin cc to Connie Hiatt (July 30, 2002). In fact, just weeks earlier, union representative Board member Tom Rhodes squarely posed the same question to Mr. Blum: whether it was proper for a Board member who was involved in meet and confer negotiations to vote on MP-2. In his response then, Mr. Blum actually gave comfort to Mr. Rhodes, stating "its [sic] fine for someone who was involved in negotiations to vote as a board member as long as that person is comfortable that he/she can vote as a fiduciary and act separately from the role as a negotiator, and actually does this." E-mail from Robert Blum to [Tom Rhodes] cc to Constance Hiatt, Lori Chapin, Lawrence Grissom, and Paul Barnett (July 3, 2002). It is inexplicable that Mr. Blum apparently reversed course less than one month later and rendered advice on the same subject, which ultimately caused Ms. Lexin to recuse herself from the November 2002 vote.

<sup>417</sup> E-mail from Robert Blum to Lawrence Grissom, Paul Barnett, and Lori Chapin cc to Connie M. Hiatt (Sept. 22, 2002).

<sup>418</sup> Letter from Rick A. Roeder to Larry Grissom, Retirement Administrator (Nov. 5, 2002).

observed that “[f]rom a purely actuarial viewpoint, it would be best to hold the City to the existing Manager’s Proposal and the 82.3% trigger.”<sup>419</sup> Nevertheless, Mr. Roeder concluded that, if the Board was set on approving MP-2 in some form, then the version of MP-2 that retained a soft 82.3% floor was “reasonable.”<sup>420</sup> Mr. Roeder repeated his lukewarm evaluation of MP-2 at a Board meeting on November 15, 2002, stating that he believed it was “inappropriate” and placed the Board in the “no-win situation” of evaluating a contribution relief proposal linked to the enhancement of its own member benefits.<sup>421</sup> However, Mr. Roeder did not change his November 5th opinion. At this same meeting, Head Deputy City Attorney Elmer Heap reported to the members of the Board that the City would be prepared to indemnify them in connection with their decision to approve MP-2.<sup>422</sup>

In a subsequent written opinion, dated November 18, 2002, Mr. Blum and Ms. Hiatt characterized the Board’s decision to approve MP-2 as a defensible choice between two alternatives. Importantly, the opinion ignores the fact that two weeks before, Mr. Blum was told by Mr. Grissom that the actuary had indicated that based on the financial data *only*, “the funded ratio will be between 80 and 82%.”<sup>423</sup> When the actuarial valuation came out, the funded ratio had sunk even lower, just as Mr. Roeder had

---

<sup>419</sup> Letter from Rick A. Roeder to Larry Grissom, Retirement Administrator (Nov. 5, 2002).

<sup>420</sup> Letter from Rick A. Roeder to Larry Grissom, Retirement Administrator (Nov. 5, 2002).

<sup>421</sup> Minutes, SDCERS Board Meeting at 29 (Nov. 15, 2002).

<sup>422</sup> Minutes, SDCERS Board Meeting at 22 (Nov. 15, 2002).

As to the origins of the indemnification provision, during the June 21, 2002 SDCERS Board meeting, at which the City Manager’s proposal to modify MP-1 was first on the action agenda, several SDCERS Board members expressed a concern about potential lawsuits deriving from their approval of the proposal. Minutes, SDCERS Board Meeting at 26-27 (June 21, 2002). In particular, John Casey noted that the SDCERS Board had recently received a letter from a local attorney (Michael J. Aguirre) threatening a lawsuit, and Diann Shipione questioned the SDCERS Board’s fiduciary counsel (Robert Blum and Constance Hiatt) about how the Board members could be indemnified if they knew they had breached their fiduciary duties as trustees. Minutes, SDCERS Board Meeting at 26 (June 21, 2002). At the July 11, 2002 SDCERS Board meeting, at which MP-2 was approved by the Board, Ray Garnica, the appointee to the Board employed in the banking industry, inquired about the status of the indemnification issue. Minutes, SDCERS Board Meeting at 28 (July 11, 2002). Mr. Garnica indicated that, if the Board were to take action on the proposal, it would do so on the condition that the City Attorney ensure the indemnification of the Board. Minutes, SDCERS Board Meeting at 29 (July 11, 2002). Mr. Garnica ultimately made an amendment to the proposal that it “be contingent upon the written confirmation from the City that it would indemnify the Board with regard to any action it takes today in the event of potential lawsuits.” Minutes, SDCERS Board Meeting at 29 (July 11, 2002). Cathy Lexin, who had made the original motion at the meeting to approve the City Manager’s proposal to modify MP-1, noted that she believed the amendment was “awkward” in terms of its necessity. Nonetheless, she acquiesced to the Board’s desire to have “written confirmation of the long-standing indemnification under the City Charter.” Minutes, SDCERS Board Meeting at 29 (July 11, 2002). The indemnification provision remained part of Ron Saathoff’s substitute motion introduced and approved later at the meeting, embodying the proposal that would come to be known as MP-2. Minutes, SDCERS Board Meeting at 33 (July 11, 2002). It should be noted that Mr. Garnica abstained from the vote approving MP-2. Minutes, SDCERS Board Meeting at 38 (July 11, 2002).

<sup>423</sup> E-mail from Lawrence Grissom to Loraine Chapin, Paul Barnett, and Robert Blum (Oct. 29, 2002).

predicted in late October.<sup>424</sup> As a result, MP-2 was a pure concession to the City, with no benefits at all – not even possible benefits – for SDCERS.

The City and SDCERS entered into a formal agreement in mid-November.<sup>425</sup> The final version of MP-2 essentially embodied the Manager's Proposal as modified by Ron Saathoff on July 11, 2002.<sup>426</sup> On the day the City Council approved MP-2, it also agreed to indemnify SDCERS Board members should they be sued for their support of the proposal.<sup>427</sup>

On November 18, 2002, the City Council met in open session to vote on MP-2.<sup>428</sup> SDCERS Board member Diann Shipione, who had voted against MP-2 at SDCERS, attended the November 18 meeting and provided a letter and made an oral presentation to the Council, warning of the dangers of MP-2 and urging Council members to vote against this agreement.<sup>429</sup>

Ms. Shipione's open letter to the Council argued:

This deal has surfaced because, under the existing 1996 City Manager's Agreement, if the Retirement Plan's funding ratio (the amount funded vs. the funding requirement designated by the independent Actuary) falls below 82.3% (which our Actuary has suggested will happen this year), the City is required to make a much larger contribution (\$25 - 75 million this year and even larger in future years) to restore the plan's funding status. It

---

<sup>424</sup> As the actuarial valuation for fiscal year 2002 showed, the funded ratio as of June 30, 2002, was 77.3%, far below the 82.3% trigger, even without regard to the *Corbett* contingent liabilities. Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2002, at 13 (Jan. 9, 2003). Although this conclusion was not yet "official" in November 2002, it was obviously known to Mr. Grissom, Mr. Roeder, Mr. Ryan, Ms. Webster, Ms. Lexin, and Ms. Vattimo, among others, including Mr. Blum. It is difficult to reconcile Mr. Blum's knowledge of the impending hit of the trigger and the complete absence of this fact from the Hanson Bridgett legal analysis. E-mail from Lawrence Grissom to Loraine Chapin, Paul Barnett, and Robert Blum (Oct. 29, 2002).

<sup>425</sup> San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002); Minutes, SDCERS Board Meeting at 29, 30 (Nov. 15, 2002) (Ronald Saathoff, Ray Garnica, John Casey, Mary Vattimo, David Crow, Fredrick Pierce, Sharon Wilkinson, John Torres, Terri Webster, and Richard Vortmann voted to approve MP-2; Diann Shipione and Thomas Rhodes were opposed); Minutes, San Diego City Council Meeting at 8-11 (Nov. 18, 2002) (Scott Peters, Byron Wear, Toni Atkins, George Stevens, Brian Maienschein, James Madaffer, Ralph Inzunza, and Mayor Murphy voted to approve the measure; Donna Frye voted against it); Agreement Regarding Employer Contributions between the City of San Diego and the San Diego City Employees' Retirement System (Nov. 18, 2002) (executed on December 11, 2002).

<sup>426</sup> Minutes, SDCERS Board Meeting at 33 (July 11, 2002).

<sup>427</sup> Minutes, San Diego City Council Meeting at 39-40 (Nov. 18, 2002).

<sup>428</sup> Minutes, San Diego City Council Meeting at 8-11 (Nov. 18, 2002).

<sup>429</sup> Videotape, San Diego City Council Meeting (Nov. 18, 2002). This was not the first occasion on which Ms. Shipione cautioned the City about problems brewing with the pension system. On May 23, 2002, she wrote to the Mayor and Board President Fred Pierce strongly urging SDCERS to conduct a comprehensive audit of the pension system in light of her concerns about material internal control weaknesses she observed. The City and SDCERS unwisely dismissed her concerns offhand and no such audit was conducted. Memorandum from Diann Shipione, Trustee, to Fred Pierce, Chair SDCERS Board (May 23, 2002); Letter from Diann Shipione, Trustee, to Honorable Dick Murphy, Mayor (May 23, 2002); Interviews by the Audit Committee with Diann Shipione (June 21, 2006).

appears that the City does not want to make these required payments. This new agreement before you today was reached to allow the City not to have to make the required payments and in return an additional employee benefit was granted. The new agreement “back loads” the entire accrued burden to the City Council of 2009.<sup>430</sup>

Ms. Shipione’s letter then made one of its central allegations – the SDCERS Board faced a conflict of interest when voting to approve the contribution scheme dictated by MP-2:

This conditioning of benefit enhancements on Retirement Board approval created conflicting concerns on the part of City and Labor representatives that sit as Trustees on the Retirement Board . . . Tying a labor contract benefit to a separate fiduciary decision co-ops [sic] the Board’s normal role as overseer of the “administration” of benefits. In a sense, it gives the appearance, if not the reality, that the City “bought” votes on the Retirement Board.<sup>431</sup>

Ms. Shipione’s letter concluded the “contingent” benefit plan and funding agreement contained in MP-2 was “ethically questionable at best, if not blatantly corrupt,” and she urged the Council to both secure the opinion of outside legal counsel and to send the issue to the Ethics Commission before voting on it.<sup>432</sup>

Despite these warnings, the Council dismissed Ms. Shipione’s statements out of hand and, after hearing a counter-argument presented by Firefighters Union President and SDCERS Board member Ron Saathoff, voted immediately after her presentation to approve MP-2. The vote regarding the contribution scheme contemplated by MP-2 passed unanimously.<sup>433</sup> The only “action” the Council took with respect to Ms. Shipione’s allegations was to request that the City Manager draft a response to her letter.<sup>434</sup>

---

<sup>430</sup> Letter from Diann Shipione, Trustee, San Diego City Employees’ Retirement System, to Honorable Dick Murphy and Members of the City Council (Nov. 18, 2002). This letter indicates that copies were also sent to the SDCERS Board, Rick Roeder, Bob Blum, and Charles Walker. Ms. Shipione was led to believe the vote in July was simply preliminary, and that the critical vote on MP-2 would be in November. Interview by the Audit Committee with Diann Shipione (June 21, 2006). After the Board approved MP-2 on November 15, 2002, Ms. Shipione spent the weekend preparing a comprehensive presentation to the Council to inform it of the dangers of MP-2 and to urge against its adoption. Interview by the Audit Committee with Diann Shipione (June 21, 2006).

<sup>431</sup> Letter from Diann Shipione, Trustee, SDCERS, to Honorable Dick Murphy and Members of the City Council (Nov. 18, 2002).

<sup>432</sup> Letter from Diann Shipione, Trustee, SDCERS, to Honorable Dick Murphy and Members of the City Council (Nov. 18, 2002).

<sup>433</sup> Minutes, San Diego City Council Meeting at 39-40 (Nov. 18, 2002); Videotape, City Council Meeting (Nov. 18, 2002) (Council members Scott Peters, Byron Wear, Toni Atkins, George Stevens, Brian Maienschein, Donna Frye, James Maddafer, Ralph Inzunza, and Mayor Murphy voted to approve; none opposed). A separate vote was taken regarding the benefits increases contained in MP-2 and only Councilmember Donna Frye opposed that motion. Minutes, San Diego City Council Meeting at 8-11 (Nov. 18, 2002) (Council members Scott Peters, George Stevens, Byron Wear, Toni Atkins, Brian Maienschein, James Maddafer, Ralph Inzunza, and Mayor Murphy voted to approve; Councilmember Donna Frye opposed).

<sup>434</sup> Videotape, City Council Meeting (Nov. 18, 2002); Memorandum from P. Lamont Ewell, Assistant City Manager, to Honorable Mayor and City Council (Dec. 6, 2002).

The City Manager's Office delegated responsibility for drafting a response to Ms. Shipione's November 18 letter to Cathy Lexin and Daniel Kelley.<sup>435</sup> Both Ms. Lexin and Mr. Kelley were intimately involved with the meet and confer negotiations and MP-2, and could hardly have been expected to give an objective response to Ms. Shipione.<sup>436</sup> Indeed, Ms. Lexin can be seen on the videotape of the November 18 Council meeting rolling her eyes during Ms. Shipione's presentation.<sup>437</sup> Although Ms. Lexin drafted the response, Assistant City Manager Lamont Ewell signed it on behalf of the City.<sup>438</sup> Mr. Ewell's letter to Ms. Shipione, dated December 6, 2002, concluded that "she has omitted, slanted and misrepresented the facts related to these matters to support her personal discomfort with the actions approved by the SDCERS Board."<sup>439</sup> After Mr. Ewell's letter, the City took no further action with regard to Ms. Shipione's allegations.

Ms. Shipione's warnings about a pension crisis and her legal and ethical criticisms of MP-2 were, on the whole, both accurate and justified. The City's cursory, dismissive response to her marks a low point in its management of pension funding issues.

#### **L. The SDCERS Report to the City Council's Rules Committee**

While the City and the SDCERS Board were busy with negotiations over MP-2, the Blue Ribbon Committee Report languished and its recommendations went unaddressed. It was not until one year after the first presentation that on February 12, 2003, SDCERS, at the Mayor's request, responded with its own report, which was presented to the Mayor and the City Council's Rules Committee.<sup>440</sup> In the intervening year, circumstances had changed considerably – among other things, SDCERS's funded ratio had

---

<sup>435</sup> E-mail from Ed Plank to Cathy Lexin and Dan Kelley (Nov. 18, 2002). Indeed, the notation "LEXIN/DEK" appears beneath Lamont Ewell's signature on the City Manager's letter in response to Ms. Shipione's November 18, 2002 letter. Memorandum from P. Lamont Ewell, Assistant City Manager, to Mayor and City Council (Dec. 6, 2002).

<sup>436</sup> Memorandum from Cathy Lexin, Human Resources Director, and Elmer Heap, Head Deputy City Attorney, to Honorable Mayor and City Council (June 14, 2002); Memorandum from Daniel E. Kelley, Labor Relations Manager, to Honorable Mayor and City Council (Mar. 15, 2002).

<sup>437</sup> Videotape, City Council Meeting (Nov. 18, 2002); Interview by the Audit Committee with Toni Atkins (Apr. 28, 2006).

<sup>438</sup> Memorandum from P. Lamont Ewell, Assistant City Manager, to Honorable Mayor and City Council (Dec. 6, 2002); Interview by the Audit Committee with Lamont Ewell (May 12, 2006).

<sup>439</sup> Memorandum from P. Lamont Ewell, Assistant City Manager, to Honorable Mayor and City Council (Dec. 6, 2002).

<sup>440</sup> Transcript, Rules Committee Meeting at 5-6 (Feb. 12, 2003); PowerPoint Presentation, San Diego City Employees' Retirement System: Report on the Mayor's Blue Ribbon Committee on City Finances (Feb. 6, 2003).

declined from 89% to 77% as of June 30, 2002; the UAAL had grown from \$238 to \$720 million;<sup>441</sup> and the City had adopted MP-2.<sup>442</sup>

The SDCERS Rules Committee Report noted the dramatic growth in SDCERS's UAAL and attributed this growth to two primary factors: declining investment performance and the effects of MP-1.<sup>443</sup> In particular, the SDCERS Rules Committee Report noted a contribution shortfall of approximately \$102 million based on the City's failure to make actuarially calculated contributions since 1996.<sup>444</sup> In addition, the SDCERS Rules Committee Report stated that: (a) the decline in the Fund's investment performance had meant that, for the first time, Surplus Earnings had not been available to pay "contingent" benefit obligations, such as the 13th Check and various *Corbett* liabilities;<sup>445</sup> (b) retiree healthcare benefits, which were paid out of SDCERS's Surplus Earnings, were now estimated to have a present value of \$1.1 billion; and (c) under MP-2, the City's actuarially calculated contribution to its pension system was projected to grow to almost 30% of its total payroll by 2009, *excluding* (i) the projected costs of "contingent" benefits, such as the 13th Check and *Corbett* payments, and (ii) an estimated \$1.1 billion in healthcare benefits.<sup>446</sup>

Clearly, by this point in time the City Council realized the growth of SDCERS's UAAL was a major problem that needed to be addressed. The City Council Rules Committee directed then-City Manager Michael Uberuaga to respond with, among other things, a fiscal plan to address the UAAL.<sup>447</sup> A series of meetings was held with, among others, Mayor Murphy and his staff, Mr. Uberuaga, Assistant City Attorney Leslie Girard, and attorneys from Luce Forward.<sup>448</sup> One of the topics under consideration was

---

<sup>441</sup> PowerPoint Presentation, San Diego City Employees' Retirement System: Report on the Mayor's Blue Ribbon Committee on City Finances at 9, 20 (Feb. 6, 2003).

<sup>442</sup> San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002); San Diego City Council Resolution R-297336 (Nov. 18, 2002).

<sup>443</sup> PowerPoint Presentation, San Diego City Employees' Retirement System: Report on the Mayor's Blue Ribbon Committee on City Finances at 15-19 (Feb. 6, 2003).

<sup>444</sup> PowerPoint Presentation, San Diego City Employees' Retirement System: Report on the Mayor's Blue Ribbon Committee on City Finances at 17 (Feb. 6, 2003).

<sup>445</sup> PowerPoint Presentation, San Diego Employees' Retirement System: Report on the Mayor's Blue Ribbon Committee on City Finances at 21-22 (Feb. 6, 2003).

<sup>446</sup> San Diego City Employees' Retirement System, Response to the Blue Ribbon Committee Report on City Finances dated February 2002 Regarding Pension and Health Insurance Funding to City Council Committee on Rules, Finance, and Intergovernmental Relations at 10-12 (Feb. 12, 2003).

<sup>447</sup> Action Items, San Diego City Council Committee on Rules, Finance and Intergovernmental Relations (Feb. 12, 2003); Memorandum from Michael T. Uberuaga, City Manager, to Honorable Mayor and City Council (Report I) (Draft "June \_\_, 2003").

<sup>448</sup> Interview by the Audit Committee with Leslie Girard (May 11, 2006); Interview by the Audit Committee with John Kern (May 5, 2006); Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

whether to hold public hearings on how to address the City's growing liability to its pension system.<sup>449</sup> Ultimately, the City Attorney's Office recommended against public hearings based on concerns that such hearings might undermine the City's legal position in the pending *Gleason* litigation, in which the legality of MP-1 and MP-2 was at issue.<sup>450</sup> Mayor Murphy agreed with this recommendation and, instead, created yet another committee of outside professionals, the Pension Reform Committee, to study the pension funding issue in July 2003.<sup>451</sup> As a result, SDCERS's growing UAAL and the potential financial crisis it posed for the City continued to go unaddressed.

### M. The *Gleason* Litigation

On January 16, 2003, a class action lawsuit was filed on behalf of retired San Diego City employees against the City, SDCERS, and Board members Frederick Pierce IV, John Torres, John Casey, David Crow, Mary Vattimo, Ron Saathoff, Terri Webster, Sharon Wilkinson, Richard Vortmann, and Ray Garnica.<sup>452</sup> The lawsuit alleged that the City, by means of MP-1 and MP-2, violated the City Charter and Municipal Code by failing to contribute actuarially appropriate amounts to SDCERS.<sup>453</sup> The lawsuit alleged that the individual defendants breached fiduciary duties owed to the plaintiff class by virtue of their involvement in the implementation of MP-1 and MP-2.<sup>454</sup> A related lawsuit alleged that certain SDCERS Board members violated the California Political Reform Act and Section 1090 of the California Government

---

<sup>449</sup> Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>450</sup> Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>451</sup> Memorandum from Mary Vattimo, City Treasurer, to Les Girard, Assistant City Attorney (May 18, 2004). Notably, by July 2003, the City Manager had largely completed two reports containing, among other things, a number of funding options to reduce the growing UAAL. Memorandum from Michael T. Ueberuaga, City Manager, to Honorable Mayor and City Council (Report I) (Draft "June \_\_\_, 2003"); Memorandum from Michael T. Ueberuaga, City Manager, to Honorable Mayor and City Council (Report II) (Draft "June \_\_\_, 2003").

<sup>452</sup> The lawsuit was captioned *Gleason v. San Diego City Employees' Ret. Sys.*, No. GIC 803779 (Cal. Super. Ct. Jan. 16, 2003). Two related lawsuits followed. All are referred to herein as the "*Gleason* Litigation."

<sup>453</sup> Complaint, *Gleason v. San Diego City Employees' Ret. Sys.*, No. GIC 803779, ¶¶ 30-34 (Cal. Super. Ct. Jan. 16, 2003).

In a lawsuit in which the legality of MP-1 and MP-2 is being challenged by City Attorney Michael J. Aguirre, Mr. Aguirre amended his cross-complaint against SDCERS to add the City as a cross-plaintiff. Subsequently, Councilmember Scott Peters and former Mayor Richard Murphy moved to disqualify Mr. Aguirre from the case because, among other reasons, the City Attorney's Office defended the City and Manager's Proposals 1 and 2 in the *Gleason* litigation, a position contrary to that taken by Mr. Aguirre in the lawsuit against SDCERS. Councilmember Peters and Former Mayor Murphy's Memorandum of Points and Authorities in Support of Motion to Disqualify the City Attorney, to Quash Subpoenas and for a Protective Order, *San Diego Employees' Ret. Sys. v. Aguirre*, No. GIC 841845, at 23-36 (Cal. Super. Ct. Jan. 27, 2005).

<sup>454</sup> Letter from Reg A. Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq., SDCERS cc to Michael A. Leone, Esq. (Mar. 5, 2003); Complaint, *Gleason v. San Diego City Employees' Ret. Sys.*, No. GIC 803779 (Cal. Super. Ct. Jan. 16, 2003).



Code by agreeing to a proposal to reduce City contributions to SDCERS in exchange for obtaining additional retirement benefits for themselves as members of SDCERS.<sup>455</sup>

In a remarkable document released only recently in connection with the pension fund investigations,<sup>456</sup> SDCERS outside counsel, Seltzer Caplan McMahon Vitek, originally recommended that (i) SDCERS *agree* that SDCERS and its Board members had violated their fiduciary duties by acquiescing in MP-2; (ii) act to nullify MP-2; and, (iii) to the extent the litigation proceeded, assert a cross-claim against the City for conspiracy to induce SDCERS and its Board to violate their fiduciary duties and seek enforcement of the full payment due from the City under MP-1 to restore the 82.3% funding level.<sup>457</sup> While SDCERS did not in fact pursue this litigation strategy, the Seltzer Caplan analysis identifies many of the legal deficiencies with MP-2 that we discuss in this report, and shows SDCERS was aware of the serious issues raised by its handling of retirement funding and administration.

In July 2004, after litigating the dispute for more than one year, SDCERS and the City entered into a settlement with the *Gleason* plaintiffs.<sup>458</sup> The settlement, which assumed, without admitting, that MP-1 and MP-2 were illegal, partially unwound the effects of MP-1 and MP-2. Pursuant to the settlement, the City agreed that it would: (i) pay the full Annual Required Contribution (calculated under the PUC method) beginning in fiscal year 2006; (ii) repeal chapter 2, article 4, division 2, section 24.0801 of the Municipal Code, which had conformed the City's contribution obligations to MP-2's payment schedule; (iii) pay \$130 million for its fiscal year 2005 contribution to SDCERS; and (iv) provide a total of \$375 million in security interests in real property as security for its required contributions to SDCERS through

---

<sup>455</sup> Memorandum from Leslie J. Girard, Assistant City Attorney, to Honorable Mayor and Members of the City Council with attached Luce Forward PowerPoint (Jan. 27, 2004). The related lawsuit was *Gleason v. San Diego City Employees' Ret. Sys.*, No. GIC 810837 (Cal. Super. Ct. Jan. 16, 2003).

<sup>456</sup> The Audit Committee requested documents from SDCERS beginning in April 2005. As previously mentioned, SDCERS first withheld documents claiming they were privileged; then produced some documents; and then delayed the production of additional documents requested by the Audit Committee until April 2006. As the document cited in the text above shows, the failure and/or delay by SDCERS to provide the Audit Committee with all relevant documents delayed the review of important information vital to its investigation. As the City's auditors pointed out in February 2005, "We have previously advised the City that we did not believe we could rely on an investigative process in which SDCERS was carved out of the investigation on the basis of the assertion that it is a separate legal entity from the City." Letter from Steven G. DeVetter, Partner, KPMG, to Richard Murphy, Mayor, Lamont Ewell, City Manager, Michael Aguirre, City Attorney, and Paul S. Maco, Vinson & Elkins (Feb. 3, 2005).

<sup>457</sup> Letter from Reginald Vitek, Seltzer Caplan McMahon Vitek, to Sheila Leone, Esq., SDCERS cc to Michael A. Leone, Esq. (Mar. 5, 2003).

<sup>458</sup> City Manager's Report No. 05-190 at 3 (Sept. 8, 2005); Settlement Agreement and Release, *Gleason v. San Diego Employees' Ret. Sys.*, Nos. GIC 803779 and 810837 (Cal. Super. Ct. July 2004), and *Wiseman v. Board of Administration of the San Diego City Employees' Ret. Sys.*, No. GIC 811756 (Cal. Super. Ct. July 2004).

fiscal year 2008.<sup>459</sup> The settlement also provided that SDCERS's UAAL amortization would be reset as of the June 30, 2004 Annual Actuarial Valuation, based on a new 30-year amortization period. Further, after fiscal year 2008, while the City would continue to contribute to SDCERS at actuarially calculated rates, the rates could finally include changed actuarial assumptions or a shortened amortization period.<sup>460</sup>

Significantly, even after the *Gleason* settlement, the City's contributions to SDCERS remained inadequate in many respects and below the contributions it would have been required to pay if based on the ARC. For example, the settlement allowed the City to continue to avoid making full Annual Required Contributions at least through fiscal year 2005; and required little immediate action to reduce a mammoth UAAL.<sup>461</sup> Even today, when the City has committed to payment of the full ARC,<sup>462</sup> it has done so based on assumptions that have been "frozen" in place since 2003.<sup>463</sup>

## **N. The Pension Reform Committee**

Despite the fact that the Blue Ribbon Committee's Report addressed the issue of pension underfunding over a year earlier, the Mayor and City Council created the Pension Reform Committee ("PRC") in September 2003 to examine the pension system.<sup>464</sup> Specifically, the PRC was charged with investigating the pension system and providing recommendations to address SDCERS's unfunded liability problems, the composition of the SDCERS Board, and to make any other appropriate recommendations.<sup>465</sup> The City Council voted to commission the PRC on September 9, 2003, and its members were appointed

---

<sup>459</sup> City Manager's Report No. 05-190 at 3 (Sept. 8, 2005); Settlement Agreement and Release at 5-7, 11, *Gleason v. San Diego Employees' Ret. Sys.*, Nos. GIC 803779 and 810837 (Cal. Super. Ct. July 2004), and *Wiseman v. Board of Administration of the San Diego City Employees' Ret. Sys.*, No. GIC 811756 (Cal. Super. Ct. July 2004).

<sup>460</sup> City Manager's Report No. 05-190 at 3 (Sept. 8, 2005); Settlement Agreement and Release at 5-7, 11, *Gleason v. San Diego Employees' Ret. Sys.*, Nos. GIC 803779 and 810837 (Cal. Super. Ct. July 2004), and *Wiseman v. Board of Administration of the San Diego City Employees' Ret. Sys.*, No. GIC 811756 (Cal. Super. Ct. July 2004).

<sup>461</sup> Settlement Agreement and Release at 6, *Gleason v. San Diego Employees' Ret. Sys.*, Nos. GIC 803779 and 810837 (Cal. Super. Ct. July 2004), and *Wiseman v. Board of Administration of the San Diego City Employees' Ret. Sys.*, No. GIC 811756 (Cal. Super. Ct. July 2004).

<sup>462</sup> Letter from Gene Kalwarski, Consulting Actuary, Cheiron, to Board of Administration, San Diego City Employees' Retirement System (May 16, 2006) *transmitting* San Diego Employees' Retirement System, June 30, 2005 Actuarial Valuation for the City of San Diego.

<sup>463</sup> Settlement Agreement and Release at 6, *Gleason v. San Diego Employees' Ret. Sys.*, Nos. GIC 803779 and 810837 (Cal. Super. Ct. July 2004), and *Wiseman v. Board of Administration of the San Diego City Employees' Ret. Sys.*, No. GIC 811756 (Cal. Super. Ct. July 2004).

<sup>464</sup> San Diego City Council Resolution R-298359 (Sept. 9, 2003). The resolution to create the PRC passed by an 8-0 vote, with Council members Scott Peters, Michael Zucchet, Toni Atkins, Charles Lewis, Brian Maienschein, Donna Frye, Ralph Inzunza, and Mayor Murphy voting in favor of the resolution. Councilmember James Madaffer was not present for the vote. Minutes, San Diego City Council Meeting at 19-22 (Sept. 9, 2003).

<sup>465</sup> Final Report, City of San Diego Pension Reform Committee at 7 (Sept. 15, 2004).

later that month.<sup>466</sup> Two PRC members, Richard Vortmann and April Boling, were also members of the BRC.<sup>467</sup>

It is unclear why the Mayor and Council chose to launch an additional investigation of the pension system in 2003 when the City Manager and SDCERS had already responded to the BRC recommendations. According to Mayor Murphy, after the BRC, there were differing proposals by City officials about how to resolve the pension crisis.<sup>468</sup> Some City officials attributed the bulk of the problem to poor investment returns, and therefore believed that the funding problem would resolve itself when market conditions improved.<sup>469</sup> Other officials favored issuing Pension Obligation Bonds, and still others believed the City needed to increase its contributions to the pension system.<sup>470</sup> Mayor Murphy stated that, as a result of this disagreement, he sought to build a consensus by selecting a committee of professionals from outside the City to suggest specific recommendations for improving the pension funding system.<sup>471</sup>

Regardless of the reason the PRC was created, one thing is certain: the process of selecting a committee to conduct an investigation and issue a report before the City took any action resulted in another delay of the implementation of any solutions for almost one more year. In fact, in hindsight, Mayor Murphy felt the delay caused by waiting for the PRC to issue its recommendations made the creation of the PRC a “mistake.”<sup>472</sup> The PRC presented interim findings to the City Council in January and again in April 2004, but its final report was not issued until September 15, 2004.<sup>473</sup> There is no clear reason why the PRC took so long to complete its investigation.

---

<sup>466</sup> Memorandum from Mayor Dick Murphy to Honorable Members of the City Council (Sept. 24, 2003); San Diego City Council Resolution R-298359 (Sept. 9, 2003).

<sup>467</sup> Final Report, City of San Diego Pension Reform Committee at 5 (Sept. 15, 2004). The other members of the PRC were Stephen Austin, Robert Butterfield, Timothy Considine, Stanley Elmore, Judith Italiano, William Sheffler, and Kathleen Walsh-Rotto.

<sup>468</sup> Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>469</sup> Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>470</sup> Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>471</sup> Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>472</sup> Interview by the Audit Committee with Mayor Richard Murphy (May 2, 2006).

<sup>473</sup> Final Report, City of San Diego Pension Reform Committee at 23 (Sept. 15, 2004). Two Minority Reports were issued along with the PRC Report – one authored by Richard Vortmann, and the other by Judith Italiano, President and General Manager of the MEA, and Stanley Elmore, Past President Retired Fire & Police Association. Neither of these reports disagreed with the PRC Report’s main conclusion that benefit enhancements and intentional underfunding contributed more significantly to the pension system’s underfunding than investment losses. R.H. Vortmann’s Minority Report, City of San Diego Pension Reform Committee (Sept. 15, 2004); City of San Diego Pension Reform Committee’s Minority Report of Members Judith Italiano and Stanley Elmore (Sept. 21, 2004).

The PRC Report concluded that the “under-funded problem” was caused by a combination of: investment performance (6% of the “problem”); underfunding by the City (10%); the use of plan earnings for contingent benefits (12%); net actuarial losses (31%); and benefit improvements (41%).<sup>474</sup> The conclusion that intentional underfunding of the pension system contributed more to the growing UAAL than poor investment returns is particularly noteworthy because it contradicted the statements of many City officials who claimed that any pension funding concerns were the result of poor market conditions.<sup>475</sup> In fact, the PRC Report stated that over the past ten years, the pension system’s investment returns were generally consistent with the system’s 8% earnings assumption.<sup>476</sup> The PRC made 17 recommendations for improving the status of the pension system, including the issuance of Pension Obligation Bonds, shorter amortization periods, increased City contributions, and the removal of retiree healthcare benefits as a pension obligation.<sup>477</sup> The City Council subsequently implemented some of the PRC recommendations; for example, it passed a resolution aimed at preventing conflicts of interest on the SDCERS Board<sup>478</sup> and an ordinance requiring retiree healthcare premiums be paid from the City’s General Fund.<sup>479</sup>

The City did *not* act, however, to implement the PRC recommendation that the City contribute annually to the pension system an amount equal to normal cost, UAAL amortization, and contingent liabilities related to that year.<sup>480</sup> This recommendation was nearly identical to the recommendation of the BRC, presented more than one year earlier, that the City fully fund its pension obligations.<sup>481</sup>

---

<sup>474</sup> Final Report, City of San Diego Pension Reform Committee at 11 (Sept. 15, 2004).

<sup>475</sup> Final Report, City of San Diego Pension Reform Committee at 11 (Sept. 15, 2004); Interview by the Audit Committee with John Kern (May 5, 2006). SDCERS Board President Fred Pierce maintained his belief, consistent with what he presented to Council in 2003, that the majority of the decline in the funded ratio was attributable to investment losses. Interview by the Audit Committee with Frederick Pierce (June 6, 2003); Transcript, San Diego City Council Committee on Rules, Finance and Intergovernmental Relations at 9 (Feb. 12, 2003). Mr. Pierce believed the PRC made an erroneous conclusion regarding the amount of the losses attributable to poor investment returns, which he attributed to the Committee’s use of an overbroad timeframe in conducting its analysis. Interview by the Audit Committee with Frederick Pierce (June 6, 2006). However, contrary to Mr. Pierce’s belief, the timeframe the PRC used is the more appropriate one to correctly evaluate the long-term effect of the City’s underfunding on SDCERS, as it also takes into account market swings over a period of time. Mercer Human Resources Consulting, Audit of Actuarial Work, San Diego City Employees’ Retirement System at 43-44 (May 11, 2004).

<sup>476</sup> Final Report, City of San Diego Pension Reform Committee at 12 (Sept. 15, 2004).

<sup>477</sup> Final Report, City of San Diego Pension Reform Committee at 14-21 (Sept. 15, 2004).

<sup>478</sup> San Diego City Council Resolution R-299583 (Aug. 10, 2004).

<sup>479</sup> San Diego, Cal., Ordinance O-19354 (Feb. 1, 2005).

<sup>480</sup> Final Report, City of San Diego Pension Reform Committee at 15 (Sept. 15, 2004).

<sup>481</sup> Blue Ribbon Committee Report on City of San Diego Finances at 23 (Feb. 2002).

While the PRC Report ultimately reached important and accurate conclusions, it was issued more than three years after the BRC first identified pension funding concerns in June 2001.<sup>482</sup> In the three years that lapsed, the looming pension crisis escalated. The system's funded ratio had dropped from 89.9% to 67.2%. The UAAL had increased from \$284 million to \$1.157 billion. The City again granted enhanced pension benefits to its employees in exchange for contribution relief. And the City had settled a lawsuit against it based on the alleged illegality of the funding scheme approved in MP-1 and MP-2, albeit a settlement allowing the City to continue contributing less than the amount required by an actuary.<sup>483</sup>

---

<sup>482</sup> Minutes, Blue Ribbon Committee on City Finances Meeting (June 15, 2001).

<sup>483</sup> City Manager's Report 05-190 at 3 (Sept. 8, 2005); Settlement Agreement and Release at 6, *Gleason v. San Diego Employees' Ret. Sys.*, Nos. GIC 803779 and 810837 (Cal. Super. Ct. July 2004), and *Wiseman v. Board of Administration of the San Diego City Employees' Ret. Sys.*, No. GIC 811756 (Cal. Super. Ct. July 2004); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2003, at 9, 13 (Jan. 8, 2004); San Diego, Cal., Ordinance O-19121 (Nov. 18, 2002); Gabriel, Roeder, Smith & Co., San Diego City Employees' Retirement System Annual Actuarial Valuation June 30, 2001, at 9, 13 (Feb. 12, 2002).